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MONOPSONY ISSUES IN AGRICULTURE: BUYING POWER OF PROCESSORS IN OUR NATION'S AGRICULTURAL MARKETS

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THURSDAY, OCTOBER 30, 2003

UNITED STATES SENATE,
COMMITTEE ON THE JUDICIARY,
Washington, DC.

The Committee met, pursuant to notice, at 2:39 p.m., in room SD–226, Dirksen Senate Office Building, Hon. Larry Craig presiding.

Present: Senators Craig, Grassley, Specter, Leahy, Kohl, and Feingold.

OPENING STATEMENT OF HON. LARRY CRAIG, A U.S. SENATOR FROM THE STATE OF IDAHO

Senator CRAIG. The Committee on the Judiciary will be in order.

We tackle and interesting and fascinating topic today: Monopsony Issues in Agriculture: Buying Power of Processors in our Nation's Agricultural Markets. Let me start by welcoming our distinguished panel of witnesses here today to discuss an issue that is very significant in American agriculture. We are here to discuss the marketplace in which nearly 2 million U.S. agricultural producers operate.

Those 2 million are directly responsible for feeding you, me, and this country, and in many instances people all around the world.

First, I think it is important to recognize that enhanced and advanced communications systems and technologies have heavily contributed to a more integrated world. Our economy faces increasingly stronger global influences and market forces. New economic relationships and the United States' resources and leadership in building these relationships around the globe have set the stage for the opportunities and the challenges that our domestic industries now encounter.

In the agricultural industry, this is particularly true. The agricultural sector is unique and involves very complex economic models and relationships when compared to others. I believe no other industry faces the same degree of uncertainty and risk that those roughly two million producers and their families encounter on a daily basis.

It is this uniqueness and attention to risk in our agricultural industry that brings us here today. Agricultural producers are desperately trying to operate in a marketplace that demands low end-use prices, yet high quality through increased efficiencies, and how

to increase producer profitability, although subjected to the status of a price taker, not a price maker.

It is no secret that today's domestic market, especially in the livestock and value-added arenas, has witnessed a significant shift from supplying meat cuts for consumers through farmer markets in the local town square, to shipping livestock hundreds or even thousands miles away to the a large packing and processing plant whose products eventually reach millions.

With this in mind, it is important to note that within the U.S., markets differ significantly by region. In the Northwest, our producers must shift their crops or livestock through limited means to markets that are few and far between. The traditional sales yard is still prevalent, yet becoming very rare. In contrast, areas such as the Midwest contain vastly larger herds that supply a much greater number of processors who may be just down the road from the farm.

Just recently one of only a few remaining packing plants in my State closed; 272 people were immediately looking for new jobs. Although this may be deemed a small operation by some standards, it represents a larger issue that producers are becoming increasingly aware of the importance that risk mitigation plays in their operational plans.

Contractual arrangements with buyers are proving more popular to combat risk, and I believe it is the responsibility of those in Congress and in regulatory positions to ensure that these arrangements are fair and not exploited.

Today, we will receive testimony from our panel that will explore their actions and thoughts on this issue of fairness in today's agricultural markets, and how the terms "monopsony" and "monopoly" adhere to this vital sector of our economy.

I hope the hearing will help shed some light on the frustration that I and my colleagues have experienced most recently in the 2002 farm bill, in sifting through all of these complicated issues. Again, we welcome you and we look forward to your testimony.

Before I turn to our witnesses, let me recognize one of my colleagues on the Judiciary Committee, Senator Grassley.

STATEMENT OF HON. CHARLES GRASSLEY, A U.S. SENATOR FROM THE STATE OF IOWA

Senator GRASSLEY. Thank you, Mr. Chairman. I appreciate your providing an opportunity for this important discussion of the negative impact of monopsonistic control and the impact it can have on family farmers and rural America.

Monopsony is to buying as monopoly is to selling. When family farmers have limited options to market their commodities, they face potential monopsonistic conditions. For decades, the Government has aggressively protected America's consumers through the Sherman and Clayton Acts from monopolistic activities. Unfortunately, the concept of monopsonies has not seemingly drawn as much attention.

Today, I hope that we take this opportunity to focus on how the Department of Justice attempts to identify monopsonistic practices. While I believe Justice attempts in good faith to remedy

monopsonies when it finds a problem, I worry that the calf has not found the creep when it comes to this issue.

I am concerned that the Department of Justice doesn't have the agricultural specialists on board who understand the unique marketing dynamics that farmers experience in their relationship with industry. The Department of Justice can't remedy the problem unless it understands the potential harm.

To the Department of Justice's credit, it has challenged or limited agricultural and agribusiness mergers in the past due to monopsonistic concerns. I know that Assistant Attorney General Pate has laid out many examples in his testimony of the Department of Justice's interest in keeping markets competitive.

One example of the Department's commitment that Mr. Pate did not describe is United States v. Rice Growers Association. Justice tried this case in 1986 and challenged the purchase of one milling firm buying another milling firm. The Department found that within the regional market, the new entity would control 60 percent of the rice purchased and that was found unacceptable to the Department.

Clearly, DOJ has the authority to act. I am just not certain that this Department of Justice, or for that matter any Department of Justice in recent history has hired professionals with the expertise and background to identify the actual markets being affected.

For instance, 87 percent of all hogs are contract or packer-owned pigs. That means that only 13 percent have the potential to be open or spot market pigs for slaughter. Over 90 percent of the hog marketing contracts are based on the composite spot market price to establish the base value. Many hogs not bound to written contracts are sold under oral formulas. The value of these types of oral agreements does not necessarily track with spot market value. In addition, hogs sold outside the western corn belt don't contribute substantively to the mandatory price reporting data.

I have seen estimates that of the 13 percent of the hogs deemed open market pigs for slaughter, only 3 to 5 percent traded daily are actually legitimate spot market pigs. The 3- to 5-percent figure sets the price daily for 90 percent of the pigs that packers have under marketing contracts.

It should be easy to understand that as the actual spot market thins out, if packers choose not to participate in the spot market everyday, packers potentially will be able to manipulate the spot market price and influence the worth of marketing contracts. I feel strongly that we need to be on the look-out for this type of manipulation of the marketplace.

Unfortunately, the potential for this type of manipulation grew considerably when Smithfield, the world's largest vertical integrator, acquired Farmland. Department of Justice staff informed my office that the Justice Department did not believe that this transaction met any threshold to justify challenging the acquisition. Justice explained that there would still be multiple purchasers in the western corn belt after this merger took place.

I have tried to take a look at the packers participating in the southern Minnesota, all of Iowa, South Dakota, and the Nebraska region. Unless the Department of Justice believes that a family farmer which produces 2,000 hogs per year, selling 40 per week,

using a trailer pulled by a pickup can reasonably be expected to deliver hogs up to 300 miles away from his farm, we definitely have a problem.

On a related topic, I would be remiss if I did not take this opportunity to voice concern not only for the spot market's impact on contracts, but for the construction of producer contracts. As the lead sponsor of the Fair Contracts for Growers Act, S. 91, I am very concerned about the abuse of arbitration clauses in take-it-or-leave-it non-negotiable contracts such as those that are typical in the livestock and poultry sectors.

Certainly, arbitration, if agreed to voluntarily by both parties involved, can be a useful tool for resolving disputes. But what we are now seeing in the livestock and poultry sectors is that arbitration clauses are being forced on farmers not as a legitimate alternative dispute mechanism, but as a mechanism to prevent farmers from challenging the abusive actions of large packers or integrators.

Farmers who are forced into arbitration proceedings are rarely, if ever, successful. In large part, this is because the process is stacked against them because arbitration does not allow for the right of discovery. If a farmer is attempting to prove that he has been treated unfairly or has been the victim of fraud, all the data that would allow him to argue his case is completely controlled by the company being accused of misdeeds. Without access to that data through the normal discovery process, it is impossible for a farmer or any grower to prove their case.

Lastly, arbitration proceedings are not part of the public record. By forcing growers to sign away their rights to resolve disputes in court, livestock and poultry companies are able to limit public knowledge about any abusive practices.

So it is easy to understand why large, vertically-integrated livestock and poultry companies might see the benefits of including mandatory arbitration clauses in their contracts. Unfortunately, we understand that farmers are often put in a position that they either have to sign the contract presented to them or face bankruptcy.

The Chairman of this Committee was the lead sponsor of a bill in the last Congress which addressed concerns about the abuse of mandatory arbitration clauses in contracts between auto manufacturers and car dealerships. That legislation, which is nearly identical in structure to the bill that Senator Feingold and I have introduced, is now law.

Our legislation would simply specify that both parties in a livestock or poultry contract must agree in writing to pursue arbitration after the dispute arises to assure that farmers choose the arbitration voluntarily. It is my hope that we will be comfortable affording farmers the same protections against abusive contract terms that we have provided for the car dealers of America.

In conclusion, I thank the Chairman for this hearing. I look forward to working with both the Committee and the Department of Justice to further explore this issue. I would also like to submit for the record the testimony of Dr. Neil Harl, from Iowa State University, whom we invited to testify today but had a conflict.

Senator CRAIG. Thank you very much, Senator Grassley. Of course, that will become part of the record.

Now, let me turn to the Ranking Member of the full Committee, Senator Leahy.

STATEMENT OF HON. PATRICK J. LEAHY, A U.S. SENATOR FROM THE STATE OF VERMONT

Senator LEAHY. Thank you very much, Mr. Chairman. I do want to thank the Committee for holding this hearing examining the buying power of processors in our Nation's agricultural markets.

I am glad to see our witnesses here. Dr. Cotterill, I am glad to have you here. He is Professor of Agricultural and Resource Economics at the University of Connecticut. I have worked with him a lot on daily matters over the years.

Monopsony is not an easy word to say, as we have all found, each one of us, as we have scrambled with that. What it means, though, is pretty easy to understand. It is the increasing power of large, concentrated agricultural processing firms and their ability to lower the prices received by farmers who supply them with milk and meat and grain. This trend is having a tremendous impact on the lives and livelihoods of American farmers in virtually every region of this country.

In my own State of Vermont, agriculture is a vital industry, and dairy is the most significant part of that. It accounts for roughly three-quarters of our State's net farm income. For decades, dairy farmers seemed immune from the consequences of restructuring because, through their cooperatives, they also served as milk processors for the local or regional markets. National markets didn't exist.

That has changed dramatically over the past few years. As a result, our farmers are not getting a fair share of the retail price of milk, but giant corporate processors are raking in anticompetitive profits at the same time they are raising prices to consumers. The price goes down to the producer, the price goes up to the consumers, and these conglomerates get the money.

My major concern in New England relates to Dean Foods, Inc., which merged with Suiza Foods in 2001 and formed the large milk processing company, not in the region, but in the world. I was really surprised and disappointed when the Justice Department's Antitrust Division approved this merger because it meant that the new company would control almost 70 percent of all the milk supply throughout all of New England.

They achieved this by buying up local dairies and then, of course, immediately closing them down. Actually, Dean Foods controls more than 30 percent of all milk production nationally, in addition to a lot of other alliances they have.

I have been concerned about last year's proposed merger between H.B. Hood and National Dairy Holdings. I led a bipartisan group of 10 Senators in asking the Justice Department's Antitrust Division to investigate the merger. It would allow one company, Dairy Farmers of America, to control more than 90 percent of the New England fluid milk supply. Fortunately, because the Antitrust Division actually looked at it, H.B. Hood withdrew its original plan, in May, and it is now being restructured.

The opportunity for dairy farmers to market their milk independently is practically gone. Today, two cooperatives control access to

most of the Nation's processing facilities. They are using this access to expand further. It is not good for daily farmers, it is not good for other market participants, it is not good for consumers.

In a competitive market, if input costs fall, competition tends to drive consumer prices lower, and that makes sure that manufacturers don't get windfall profits. But that doesn't work in the dairy industry. Retail prices for fluid milk are virtually unchanged this year, even though prices that farmers receive are off 50 cents per gallon.

I think the Justice Department should still investigate why lower farm prices for milk have not been passed on to consumers. I have asked the General Accounting Office to investigate this disparity between farm and retail milk prices. It is not just important for Vermont; it is important for the daily industry country-wide to establish greater protections against market abuses by huge agribusinesses.

I think the American people and the farmers who produce America's agricultural goods deserve strong watch-dogging by their Government. If we have strong watch dogs here, it works, and it is going to help the market opportunities for America's farmers and ranchers. It is also going to protect farmers and ranchers against those who have such enormous power to just overcome anything they might do.

Mr. Chairman, I have a much longer statement and I would ask to put it in the record.

Senator CRAIG. Without objection, your full statement will become a part of the record. Thank you very much for that.

[The prepared statement of Senator Leahy appears as a submission for the record.]

Senator CRAIG. Let me turn to another member of our Committee, Senator Herb Kohl.

STATEMENT OF HON. HERB KOHL, A U.S. SENATOR FROM THE STATE OF WISCONSIN

Senator KOHL. Thank you, Mr. Chairman. Thank you for holding this hearing to examine the troubling trend of increased concentration in the agricultural industry.

The alarming transformation of rural America continues. Increased concentration on the buyer side has dramatically shrunk the market for farmers and driven many out of business. It is clear that now more than ever, we need vigorous and aggressive enforcement of our antitrust laws to prevent concentration that harms competition in this marketplace.

We need to seriously examine whether our antitrust laws are being properly enforced to prevent excessive agricultural consolidation. Antitrust enforcement should not permit the creation of dominant market power by a buyer of agricultural products any more than it would permit the creation of a monopoly by a seller. In addition, antitrust regulators should be sensitive to the effects of consolidation in regional markets, as many agricultural products are perishable.

We must ensure that the Justice Department devotes sufficient resources and staff to the agricultural sector. Our farmers and ranchers, less than 2 percent of our population, produce the most

abundant, wholesome, and by far the cheapest supply of food in the world. Yet, prices fall for farmers as they find fewer and fewer buyers for their products. And despite this, prices stagnate or even rise for our consumers.

This trend is evident across commodities. From 1993 to 2001, the share of hogs sold through contractual arrangements increased from 10 percent to 72 percent. In poultry, nearly 100 percent of the market depends on contractual arrangements.

Of greater concern to me, the dairy industry is experiencing the effects of processor concentration. Dairy producers in Wisconsin and around the country recently emerged from a 20-month period where milk prices hit a 25-year low. The U.S. fluid milk market is a $23 billion-a-year industry. The combination if Suiza and Dairy Farmers of America now controls approximately 70 percent of the fluid milk processing and distribution in 13 northeastern States.

This concentration in buying power at the processor and retail level has not led to lower prices for consumers. In fact, 2 months also when the national average price paid to farmers for fluid milk declined by 13 percent, the average national retail price paid by consumers at the grocery store declined by only 5.5 percent.

Rural America is in crisis. Their way of life and economy, countless communities, and too many farm families are struggling because there is a dwindling free market for American agriculture's superior product. We need to revisit the way our antitrust laws are being applied to agriculture. We need to discard the outmoded doctrine that buying power is treated with a lower degree of scrutiny than the aggregation of selling power.

Dominant buying power among food processors ought not to be permitted any more than a monopoly among food retailers. Dominant regional market shares should be permitted no more than dominant shares in national markets.

We need to ensure that the Justice Department enforcement tools are adequate to do their very important job. We were pleased several years ago when the Justice Department appointed at our request a special counsel responsible for competition in agriculture. However, serious questions have been raised as to whether the Justice Department has devoted sufficient resources to this task. We need to scrutinize the Antitrust Division to ensure that it is devoting sufficient resources and manpower to competition in agriculture.

We are pleased to welcome our witnesses, and for me particularly Peter Carstensen, from the University of Wisconsin Law School. I have always been impressed with Mr. Carstensen's work on this issue, and so we all look forward to a productive hearing.

Thank you, Mr. Chairman.

Senator CRAIG. Senator, thank you very much.

Now, let us turn to our first panel and our first panelist, Senator Tom Harkin, of course, Ranking Member of the full Senate Ag Committee. We know that these are issues awfully important in his home State.

Senator please proceed.

STATEMENT OF HON. TOM HARKIN, A U.S. SENATOR FROM THE STATE OF IOWA

Senator HARKIN. Thank you very much, Mr. Chairman, and thank you for the opportunity to be here and for holding this hearing. I, first of all, want to associate myself with the statements I heard from Senator Grassley, Senator Leahy and Senator Kohl. I think they are right on the mark on this, and perhaps some of the things I will say will be repetition, but maybe just with a little different slant.

The consolidation horizontally and vertically in the processing and retail sectors of our food industry is a real problem facing rural America. We sometimes forget that the goal of antitrust policy was to protect small firms, like independent farmers, that sell their goods. As Senator Kohl pointed out, it is not just the buyers, but also the sellers that need to be protected when they deal with an anticompetitive and consolidated market.

As ranking member, as you point out, Mr. Chairman, of the Agriculture Committee, I am too familiar with the numbers. Eighty percent of steer and heifer slaughter is controlled by four firms. Soon, 64 percent of all hog slaughter will be controlled by 4 firms. You have heard a couple of people speak about the dairy industry and what is happening in certain parts of our country in the dairy industry.

Well, just as these industries have become more horizontally consolidated, they have also increased the use of vertical arrangements. Hog packers now have 80 to 90 percent of their supply tied up in some type of a vertical arrangement. These are just a few examples of the increased horizontal consolidation and vertical integration in agriculture.

The essential problem with consolidation and vertical integration, when taken too far, is that such trends reduce choice and efficiency in the marketplace. The lack of choice leads to unequal bargaining power in business relationships. With unequal market power, the more dominant firm will always take advantage of the more vulnerable party by squeezing price, shifting liabilities, or demanding certain terms without paying an associated price.

Again, as Senator Kohl pointed out, Congress enacted the Sherman and Clayton Acts not only to protect consumers from sellers who have too much power, but also to protect sellers from buyers who have too much power.

One of the most disturbing news that we have seen out our way is the recent acquisition of Farmland Foods by Smithfield—again, just another example of what we are talking about here. Many of us wrote letters and signed on to letters to the Attorney General expressing grave reservations about Smithfield acquiring Farmland. But the Department seemed to ignore the concerns of independent producers and they let the deal go through untouched.

Of course, Smithfield's acquisition of Farmland will strengthen its leverage over family pork producers and represents even more concentration and vertical integration in the already rapidly consolidated pork processing industry.

Smithfield's version of hog production in which it owns all of the hogs and reaps all of the entrepreneurial profit does not bode well for the future of the rural Midwest. Smithfield has a history of

shutting down plants that it buys. Yet, even if the plants remain open, the market would still lose a buyer and become even more concentrated. But despite Smithfield's past actions and the potential degree of control they would hold over the sector, the Department of Justice allowed the acquisition to go through untouched.

As Ranking Member of the Ag Committee, I realize the job of addressing competition problems in agriculture does not lie solely with your Committee. The Ag Committee has jurisdiction over the Packers and Stockyards Act, the Agricultural Fair Practices Act, and the Perishable Agricultural Commodities Act.

Again, all of these laws are designed to protect producers from unfair trade practices or help producers gain bargaining power through cooperatives. In fact, one of the reasons I wanted to testify today, Mr. Chairman, was to invite more cooperation between our two committees to work together to protect farmers against unfair and anticompetitive conduct.

In conclusion, I want to thank you for convening this very important hearing. This may not make the front page of the New York Times. It may not be the headline on the CBS Evening News, but in terms of the number of people that are being affected by this horizontal consolidation and vertical integration in agriculture, it probably dwarfs anything the news is going to cover tonight, or tomorrow on the front page.

Whether they realize it or not, this ripples through the food chain. It ripples through the food markets, through the grocery stores, and right down to the consumer level. So that is why the business you are about is important for the free market, and it is important for our producers as well as our consumers.

Thank you very much, Mr. Chairman.

Senator CRAIG. Senator Harkin, thank you very much for that statement.

Senator Feingold, we have allowed opening statements by all of our colleagues today. So if you so have, please proceed.

STATEMENT OF HON. RUSSELL FEINGOLD, A U.S. SENATOR FROM THE STATE OF WISCONSIN

Senator FEINGOLD. Thank you, Mr. Chairman. That is very kind of you.

I appreciate your holding this hearing to shed light on an important issue for farmers and their families. I must say I am awfully pleased to be with this group of Senators, including Senator Harkin, all of whom have shown enormous leadership in this area.

I appreciate the opportunity to briefly share my views on the power of buyers in our agricultural markets. Increased consolidation and market concentration are, without question, a very significant concern for producers throughout the Nation. As I travel throughout my home State of Wisconsin, these issues are raised constantly by farmers and growers.

Monopsony power is a serious concern because this power can so easily be abused. When there is only one buyer of a commodity, farmers fear that the price that they receive and the terms of the transaction will be unfairly biased against them. Farmers are rightfully troubled by inadequate market access, price discrimination against the small independent producer, and, of course, the

loss of negotiating power for the men and women who actually produce the product.

I am pleased to be an original cosponsor of the Fair Contracts for Growers Act of 2003, and I have been delighted to work with Senator Grassley on this issue. It addresses one unfair result—monopsony power in this industry. It is designed to provide greater fairness in the arbitration process relating to livestock and poultry contracts.

I believe that arbitration can be an effective and appropriate method to resolve disputes between farmers and those who purchase their products, but only when both parties voluntarily participate. Many farmers, however, due to their disadvantaged economic position, are forced to sign contracts presented to them by large processing firms that include mandatory arbitration clauses.

There is no negotiation between the farmer and the processor in these instances. Farmers must accept the contract as written, waiving their constitutional right to have their disputes under the contract decided by a trial by jury.

I would like to submit a letter for the record, Mr. Chairman, from numerous farm and consumer organizations, as well as advocates for animal protection in rural communities, expressing their support for the Fair Contracts for Growers Act.

Senator CRAIG. Without objection.

Senator FEINGOLD. Thank you, Mr. Chairman.

The Senate and this Committee have both demonstrated strong bipartisan support for rectifying the injustices of mandatory arbitration. During the debate on the farm bill in the last Congress, I offered an amendment with Senator Grassley to prohibit the use of mandatory arbitration clauses in livestock and poultry contracts. Our amendment passed the Senate by a vote of 63 to 31, but it was dropped in conference.

This Committee has supported similar arbitration measures in the past, such as the auto dealer arbitration bill that the Chairman worked to enact in the 107th Congress. The Fair Contracts for Growers Act addresses only one piece of this complex business relationship in agricultural markets that are becoming increasingly concentrated. The growing concentration of agricultural buyers raises serious questions about the Department of Justice's enforcement of existing laws, as well as the adequacy of those laws to ensure a fair, open, and equitable market.

Again, I thank the Chairman for letting me speak.

Senator CRAIG. Thank you very much, Senator.

Now, let us turn to our second panelist and ask him, if you, Mr. Pate, to please come to the table.

Our second panelist today is R. Hewitt Pate, the Assistant Attorney General for Antitrust. Mr. Pate became the Assistant Attorney General for Antitrust this past June, but served as an Acting Assistant Attorney General from November 23, 2002, until his confirmation by the Senate.

My guess is that some of our colleagues might be, and have already been a bit critical of actions by or failure to act by the Office of the Attorney General on certain issues. So we are anxious to hear from you, Hewitt, as it relates to the work that is underway in the Justice Department on these critical issues.

STATEMENT OF R. HEWITT PATE, ASSISTANT ATTORNEY GENERAL, ANTITRUST DIVISION, DEPARTMENT OF JUSTICE, WASHINGTON, D.C.

Mr. PATE. Thank you very much, Mr. Chairman and members of the Committee. I would start by saying that I welcome the scrutiny. In our system of Government, that is how we improve our public institutions, and so I appreciate the opportunity to appear before this Committee today.

I have a longer written statement, but I would like to begin with a briefer statement, if I may.

Senator CRAIG. Your full statement will be a part of the record. Thank you.

Mr. PATE. Thank you, Mr. Chairman.

The agricultural marketplace, as many of you have mentioned, is undergoing significant change—international challenges, technological innovation, and new forms of business relationships. In the midst of these changes, farmers are rightly concerned about whether agricultural markets are remaining competitive. We take these concerns very seriously. We know that competition at all levels in the production process leads to better quality, more innovation, and competitive prices. Enforcement of the antitrust laws can benefit farmers as purchasers of goods and services that allow them to grow crops and raise livestock, just as it also protects consumers of the crops that they raise and sell.

We have been very active in enforcing the antitrust laws in the agricultural sector. We have also undertaken a special outreach effort, meeting with producers and producer groups in Washington and around the country to listen to their concerns and to improve everyone's understanding of the role of the antitrust laws.

This afternoon's hearing focuses on monopsony, and I think it is fair to say that, more than some other industries, agriculture has a structure that makes so-called monopsony concerns more likely to arise. That is because the industry is characterized by many smaller producers selling to fewer and larger processors.

We are sensitive to this and we look closely at so-called monopsony concerns in enforcement. Monopsony is the mirror image of monopoly, but, of course, on the buying side rather than the selling side. This is an antitrust concern because if market power is created that enables a buyer to reduce the quantity it buys in order to force down the per-unit price it pays, and if that depresses producer incentives and brings output down below the competitive level, then society is deprived of the benefits of the full amount of production that should take place in a competitive economy.

The competitive harm to suppliers thus can lead directly to competitive harm for consumers. So focusing on promoting competition goes hand in hand with our taking enforcement action in a monopsony case when the facts warrant.

As you all well know, we bring three types of antitrust enforcement actions typically. Under Section 1, we both criminally and civilly prevent combinations and collusion that damage competition. We bring actions under our monopolization statute, Section 2. And finally, of course, under Section 7 of the Clayton Act, we are responsible for merger enforcement and for preventing mergers that substantially lessen competition.

We have been active under each of these headings. In our criminal enforcement program, we have taken action in a number of cases that have resulted in savings to farmers in the case of feed additives, herbicides, and otherwise, where they have been the victim of price-fixing and illegal cartel activity. Likewise, on the criminal side, a few years back we have prosecuted cattle buyers, where they have been guilty of bid-rigging in the purchase of cattle.

In terms of merger enforcement, we have active now a case called Southern Belle, in Kentucky, in the milk industry. This was a case which actually fell below the Hart-Scott-Rodino thresholds and has closed, but nonetheless we are engaged in litigation there.

As has been mentioned in previous remarks this afternoon, the NDH/Hood dairy merger was withdrawn during the Department's scrutiny of that merger. We have taken efforts to be more transparent with parties about our concerns as we go through the course of an investigation. In that case, that appeared to result in a transaction being withdrawn. It has been modified and a different transaction is under review now. That process is ongoing.

Likewise, the Cargill/Continental case and the Suiza/Dean case were mentioned earlier. In Cargill/Continental, we explicitly recognized the need to protect producers from monopsony concerns. And in Suiza/Dean, while the transaction was not stopped outright, we demanded significant divestitures in that transaction to protect competition.

So we have been active throughout this market, throughout the tools at our disposal to try to protect competition, and I look forward to answering your questions about our work this afternoon.

Thank you.

Senator CRAIG. Hewitt, thank you very much for your testimony and for being here.

Let me now turn to my colleague, Senator Grassley, for an opening round.

Senator GRASSLEY. Mr. Pate, I would like to start by stating once again that I think that you have statutory authority to pursue monopsonistic activities. My concern is that the Department of Justice has not established specific guidelines or brought on enough expertise to properly address that issue.

This isn't to say that the Department of Justice is doing a worse job than any past Department of Justice. So, in fairness, I haven't been happy with Departments of Justice on this issue of agribusiness through several administrations.

Does the Department of Justice have specific authority to determine the competitive impact of vertical integration in agriculture on farmers?

Mr. PATE. There is no question that we have the ability, and we do in specific mergers look at vertical concerns. There is no question that we have authority to look at monopsony, as well as monopoly. We did that explicitly in the Cargill/Continental case. That was part of the Suiza/Dean inquiry I mentioned. It was part of what we were looking at in NDH/Hood. So the answer to both of those is yes.

Senator GRASSLEY. Do you follow specific guidelines that you have in writing to measure?

Mr. PATE. Our horizontal merger guidelines, for example, are constructed around the more typical situation of seller side power and monopoly. Monopsony is the mirror image of that. So the same considerations that would apply on the monopoly side apply in analyzing monopsony.

That is not to say the cases are in every event the same. As I have discussed, I agree with some of the comments made earlier that agricultural markets can be different than other markets. We look case by case at every transaction, but consistent with the guidelines we have on the monopoly side, when we look at monopsony questions.

Senator GRASSLEY. You referred to Cargill/Continental. In that merger, the Department of Justice required partial divestiture. Has the Department of Justice performed any analysis to determine whether that divestiture has preserved competition?

Mr. PATE. Typically, we do not do retrospective examinations of markets, except that when we face future transactions or enforcement actions, then we get the opportunity to look back in that context. But it is not generally part of what we do to conduct studies.

We do have two sections within the Department who stay abreast of agricultural issues and are specifically responsible for them, and they do keep up in date in terms of market trends in those areas. So I am sure that attorneys within those sections have some of the information of the type you are talking about.

Senator GRASSLEY. Did the Department of Justice study hog-buying practices by packers and the impact of those practices on competition before approving the largest pork integrator merger in U.S. history?

Mr. PATE. If you are referring to the Smithfield/Farmland merger—

Senator GRASSLEY. Yes.

Mr. PATE. —I was recused from that case. I did not participate in it, so I can't tell you directly about the nature of that investigation. Before coming to the hearing today, I learned that the Department sent to Attorney General Miller, in Iowa, describing its activities.

On that basis, I can tell you that certainly the answer is yes, and that as would be the case in any case that we examine, we would look at producers, consumers, the companies that operate in that market, and determine what the market facts were in the case.

Senator GRASSLEY. Eighty-seven percent of all hogs are contracted or packer-owned; 13 percent are deemed open-market. Those are statistics I used in my opening remarks. In practice, then, as I have previously said, 3 to 5 percent of the hogs traded set the national price, and that surely happens in the Midwest.

Ninety percent of the hog marketing contracts are tied to a composite average of the spot market for compensation. Many spot-market hogs are sold under oral formulas, and open-market hogs sold outside the western corn belt don't contribute to price-setting. This leaves the remaining pool of spot-market hogs very limited. Yet, those pigs set the price for all hogs tied to marketing contracts throughout the country.

The western corn belt market is at its core made in Iowa, Minnesota, South Dakota, and Nebraska. This is where those 3 to 5

percent of the true spot market hogs are located. When the Department of Justice allows dominant integrators to command the southern Minnesota-northern Iowa markets, you give integrators the opportunity to limit spot market purchasing and prices. Spot markets are easier to manipulate than higher-volume markets. That is just the plain fact.

So my question is does the Department of Justice recognize the power integrators have in thin spot markets and that the western corn belt is the dominant price-setting region for hogs in the United States?

Mr. PATE. I read with interest some of the testimony on these points that Professor Carstensen submitted. There is no question that it is correct to observe that a more thinly traded market is less likely to establish a competitive market price than one in which there are more participants.

The antitrust laws in our reviews don't go generally to the question of whether an auction or an open sale process, on the one hand, or contracting on the other is to be, as a general matter, as preferred form of contracting. When we do a merger analysis, the question we are asking is whether the merger itself is likely to lead to a decrease in competition. But we would look at the question of the effect on both auction markets and contracted purchasers when we do that.

Senator GRASSLEY. I would have two questions in writing, two questions to follow up on my first two questions, and then I have one question I did not ask. So I will submit those.

Senator CRAIG. Senator, thank you. We will submit questions in writing. Senator Leahy also has questions that he will submit in writing to all of our panelists.

We have a vote on. I am going to turn to Senator Specter to make any opening comments and offer any questions he might have. I am going to leave for the vote. If you would recess the Committee at the conclusion of your thoughts and questions, that way we can be back and keep it going, and honor some reasonable time to our third panelists, also.

Thank you.

Senator SPECTER [PRESIDING.] Well, thank you very much, Mr. Chairman, and thank you, Mr. Pate, for the job which you are doing.

Senator Grassley made a comment about his evaluation of the Department of Justice. He has been active in evaluating the Department of Justice for many years. I recall the first Attorney General that Senator Grassley worked with was William French Smith, and Senator Grassley had some substantial disagreements with Attorney General William French Smith.

One day at a social event at the Department, the Attorney General turned to me and said, why are you so critical of me?

Senator GRASSLEY. He was obviously getting us mixed up.

Senator SPECTER. What did you say?

Senator GRASSLEY. He was obviously getting us mixed up.

Senator SPECTER. Can you imagine such a blight on Senator Grassley to be confused with me?

[Laughter.]

Senator SPECTER. After the hearings on Justice Thomas, I heard many reports.

What were those, Senator Grassley?

Senator GRASSLEY. Those reports were why was I so mean to Anita Hill, and I never asked her one question. They were getting me mixed up with you.

Senator SPECTER. You can see what a terrible situation he has had for 23 years to have to sit next to me on the Judiciary Committee.

Senator GRASSLEY. That is why I am leaving now.

[Laughter.]

Senator SPECTER. So I advise you, Mr. Pate, to be very wary, very wary of Senator Grassley even when he is gone.

Mr. Pate, I am glad that we are having this hearing on monopsony. That is a subject matter which is a word almost never, never used, but one of great importance. I am very much concerned about the impact on dairy farmers. As we have seen in Pennsylvania, the price of milk at the store goes up and the price of milk to the farmer goes down. The fluctuations have been very extensive, sometimes more than $16 a hundredweight, and then in a short period of time, less than $10 a hundredweight.

We have had a series of hearings on trying to understand why it is that the farmer gets a lower price and the grocer gets a higher price simultaneously. It may be that monopsony is the answer, that a single buyer or a limited number of buyers are able to deal with many purchasers to exert, in effect, monopoly power which drives down the price to the producers.

Do you have any thoughts on that subject?

Mr. PATE. Well, again, it varies from case to case. It could be the case that there is a monopsony problem on the purchase of raw materials side, but no problem on the consumer side of the market because there is vigorous competition on the selling side.

The reverse could be true, or there could be problems of market power on both sides of the transaction. That could be true in the dairy or other industries. So that would be something we would evaluate case by case when we are reviewing a transaction.

Senator SPECTER. There is substantial competition in the marketplace for sellers of milk. There may not be for buyers of milk. I am glad to hear your agreement that the Department of Justice has full power to deal with monopsony, and I think there really needs to be a very, very vigorous pursuit of that line.

We are still struggling with the problem of what is happening in Pennsylvania and we are in the process of preparing legislation which would tie the price of milk to the cost of production. We face a very serious problem about having the small milk producer going out of business, and at the current rate we may have an greater problem with the small dairy producers. So the activities of the Department of Justice could be very, very helpful.

I recollect your Department's intervention with the matter of a small company in St. Mary's. It wasn't milk; it was a manufacturer. But the Department of Justice can have a tremendous impact. Just to show an interest and to seek an inquiry in an investigation can be very, very helpful.

As Senator Craig said, we are in the middle of a vote and I am going to have to depart momentarily to make the vote. We have 15 minutes and a 5-minute overlap. We have a very, very busy schedule today trying to finish up the business of the Senate and I am going to try to return, but I am not sure that I can. Mike Oscar, my deputy, is here and we will be paying very close attention to what your Department does on this important subject.

I have been advised that Senator Kohl has some questions for you, Mr. Pate. So we would appreciate it if you would remain. Senator Kohl should not be too long in returning.

Mr. PATE. Thank you, Senator.

Senator SPECTER. The Committee will stand in recess for a few moments.

[The Committee stood in recess from 3:29 p.m. to 3:39 p.m.]

Senator CRAIG [PRESIDING.] The Committee will reconvene. Thank you all very much for your patience.

Let me turn to my colleague, Senator Kohl.

Senator KOHL. Thank you, Senator Craig.

Mr. Pate, as we have been saying, traditional antitrust doctrine gives less scrutiny to buyers gaining dominant market positions than to sellers gaining dominant positions via monopolies. This is because monopsonies have the potential to result in lower prices to consumers.

In the agricultural sector, we have seen in recent years tremendous buying power gained by food processors, resulting in depressed prices and substantial economic losses to farmers. In fact, as we have said, the top 4 beef packers now control 81 percent of the market, the top 4 pork processors control 59 percent 9of the market, and the top 4 poultry processors control 50 percent of the market. All of these percentages are going up considerably.

In light of this consolidation, shouldn't we now treat monopsony in agriculture with the same scrutiny that we give to monopolies? Shouldn't we be particularly concerned about buyers gaining dominant market positions with respect to agricultural goods, Mr. Pate?

Mr. PATE. We are particularly concerned about it. I think it is not fair to say that the law has established that there should be less scrutiny, but simply that there have been fewer cases where this comes up. We are more used to dealing with cases where the alleged harm is on the side of sales, but we equally do look for monopsony problems.

I think there is some comment today that is repeated that it has been established that monopsony can produce anticompetitive harms at lower levels of concentration than monopoly. While I think that is a claim that is asserted, it is not one that has been studied by economists and backed up, but is one that should be looked at. And if it could be proven that that is true—I know, for example, Senator Kohl, you have been interested in this possibility in the group purchasing area in the health care field.

This is something that I think we need to look at and determine whether it is the case and then tailor our enforcement efforts accordingly. But we do look at monopsony concerns. As you say, we do have to be concerned that we not act in situations where we are preventing lower prices and better products to consumers. But the concerns I am hearing here today are about situations where the

monopsony side is causing losses to the producers, but yet that isn't passed through.

Senator KOHL. Well, it has been pretty well demonstrated now that over the course of many, many months, for example, milk prices have been at record lows, or world-record lows, and there was nothing even comparable reflected at the retail level in prices to consumers. I don't think there is any question about that occurring and with respect to what has obviously become a demonstrated consolidation of cooperatives and providing farmers with virtually no one to sell to except a single co-op.

How much more studying do you need to do before you—I am not trying to be disrespectful, but when do you make a conclusion that this is not the right way in which we should be going and then try and find a remedy, which I would be the first to agree is not easy?

Mr. PATE. Well, in particular cases we don't find that hard at all. That is why, while there may be disagreement as to whether our divestiture was the correct solution, in Suiza/Dean we took aggressive action to require divestiture, why in the face of divestiture the NDH/Hood transaction was withdrawn. That is why we are taking action in the Southern Belle case. That is why we took action in Cargill/Continental.

As to generally solving that problem—and I know reference was made to legislation that would peg retail prices to percentages or to multiples of the raw milk price. That is something that is mentioned in Mr. Cotterill's statement as New York legislation that has proposed that. That type of direct price regulation and market outcome-dictating solution is not one that the antitrust laws are involved with.

So case by case, we are going to be there enforcing. Can antitrust law address every non-antitrust structuring of the market that some policymakers might think is appropriate? No, that is not what it is intended to do.

Senator KOHL. I must say I still have this concern that when all is said and done and another year goes by or 2 years go by, in spite of this tremendous consolidation that is occurring and continues to occur in, for instance, the beef packing industry and milk processing, and hogs and poultry, there will not be—and I hope I am wrong—sufficient action on the part of your Department.

We were pleased when several years ago the Antitrust Division appointed a special counsel for agriculture that we had requested. It is important that a senior staff member be responsible for supervising and directing the division's enforcement efforts, but aggressive enforcement in this sector requires much more than just the supervision of one senior official. What is important is that the Antitrust Division devote sufficient resources and manpower to monitor and investigate competition in the agricultural sector.

Could you please tell us the amount of current resources both in terms of funds expended and staff employed on competition in the agricultural sector, and has this changed significantly over, say, the last 5 years?

Mr. PATE. I can give you a sense of that. In terms of budget breakdown, I don't have a dollar figure in terms of hours spent. I can tell you that we have two sections in which we have substantial attorneys devoted to agricultural enforcement.

We have a transportation, energy, and agriculture section that deals with agriculture matters. In our Lit I section, we have a number of attorneys who are specifically focused on the dairy industry. These cases often are pretty intense. In Suiza/Dean, for example, in addition, we had 8 economists and 13 lawyers working on that case while it was open. So at any given time, we may have many tens of attorneys and economists working on agricultural matters. It depends on what is active at the division.

Mr. Ross, as you mentioned, coordinates that. Agriculture is the only area that has a specific special counsel assigned to it at the division. I do not think, based on what I know, that there has been a significant change in resources over a 5-year period. I would say that there has been an increase in the attention paid to it. I think Mr. Ross' presence there is a part of that that is constructive.

I hope that is helpful in answering your question.

Senator KOHL. Some in the agricultural industry have argued that the Department of Agriculture should have a greater role with respect to examining consolidation in the agriculture industry. In other industries, the Justice Department sometimes gives advice to the department that regulates that industry.

For example, when the FCC is considering whether to allow a local phone company to offer long-distance service, the Justice Department gives the FCC advice on whether the local phone company has opened its facilities to competition.

Mr. Pate, how does the Justice Department make use of the Department of Agriculture's expertise when considering agricultural mergers? Are there more steps that you might take to ensure that USDA has a role in providing Justice with its expertise and views regarding your review of transactions in agriculture?

Mr. PATE. Senator, that is a good question. We have a memorandum of understanding between the Justice Department and the USDA in terms of our need to cooperate on mergers and other matters. We make use of that in every case.

I know even in the Smithfield matter, on which I know there is a good deal of concern, I noticed that the letter to Attorney General Miller specifically notes that we consulted and got input from the Agriculture Department there.

I think comparing it to the telecom industry or others, I am not sure that the situation calls for any sort of specific statutory assignment. I think it is something we should pay attention to. Since I came on board, we have scheduled and put in place a meeting with the front offices of USDA and the Antitrust Division to try to share information on competition issues in agriculture, agricultural issues that affect competition and our mission. So that is something we do readily and I think need to continue to do and do more of.

Senator KOHL. Thank you, Mr. Chairman.

Senator CRAIG. Herb, thank you very much for those very thoughtful questions.

I have one question only. There are others I will submit for the record for the sake of time so we can get our third panel up. We are in active business over on the floor at the moment and I think the plan a series of additional amendments. So we will try to expedite as much as possible.

Attorney General Pate, I have to admit that the very word "monopsony" threatens to give me a headache, in at least attempting to understand it. I think that Senator Kohl was pursuing this in a variety of ways through his questions, but how difficult, or easy for that matter, is it for you and your staff to assess the threat that monopsony behavior possesses in the marketplace? Is there a relatively easy formula that the myriad of your economists and attorneys look at?

Mr. PATE. I think there is not an easy formula. As some have mentioned here this afternoon, we have somewhat less experience with it. I have got a Webster's unabridged dictionary in my office and I looked up "monopsony" before coming over to the hearing and it wasn't in there—the first word I have ever failed to find. Now, this isn't a new dictionary, but the point I am making is that we have had less experience with it. It is something that our economists have less experience with.

As I said, though, in many cases it would be the mirror image of monopoly, to which we have written guidelines and more experience. But even in those cases, we don't have ready-fit guidelines. We have to take each case on its own bottom and look at the market facts.

Even in the context of something such as our HHI numbers, they are not a cut-out formula that decides cases. So I don't think it is necessarily something that is more difficult. It is something we do have less experience with over time.

Senator CRAIG. Well, we thank you very much for your presence here today. As I say, there will be a series of questions coming your way so that we can have a complete and full record and we will appreciate your responding to them, and your staff. Thank you very much.

Mr. PATE. Thank you, Senator.

[The prepared statement of Mr. Pate appears as a submission for the record.]

Senator CRAIG. Now, let us turn to our third panel today, consisting of three distinguished professors, and maybe they will be able to shed light on the why Webster's failed to put this in at least the edition of the dictionary that Mr. Pate has.

We will hear from Dr. DeeVon Bailey, who is a professor and extension economist at Utah State University. I understand, Dr. Bailey, you live in the Cash Valley, which is a greater extension of southern Idaho.

Mr. BAILEY. Well, we don't look at it that way.

Senator CRAIG. We will let you respond to that in your testimony.

Also, we have with us Dr. Ron Cotterill, who is a Professor of Agricultural and Resource Economics at the University of Connecticut. Last, but certainly not least, we will hear from Professor Peter Carstensen, who is George H. Young-Bascom Professor of Law at the University of Wisconsin, in Madison.

Gentlemen, again, thank you. Dr. Bailey, please proceed.

STATEMENT OF DEEVON BAILEY, PROFESSOR AND EXTENSION ECONOMIST, DEPARTMENT OF ECONOMICS, UTAH STATE UNIVERSITY, LOGAN, UTAH

Mr. BAILEY. Thank you, Mr. Chairman. If you think "monopsony" is a difficult word, actually the correct term is more "oligopsony," which indicates that there are a few buyers, not just one.

Senator CRAIG. I just learned "monopsony." Let's stay with that, all right?

Mr. BAILEY. Indeed, I am from Utah and I am a professor and extension economist in the Department of Economics at Utah State University. I grew up in the small farming community of Paradise, Utah, which is in the Cash Valley, certainly one of the most beautiful places on Earth.

Senator CRAIG. We judge that by the flow of the Bear River.

Mr. BAILEY. Yes.

Senator CRAIG. It flows out of Idaho, through the Cash Valley, into the Great Salt Lake. So we do expect and understand that it is an extension of the greater State of Idaho. Thank you.

Mr. BAILEY. I will not argue with you on that point, Senator.

I did grow up working on my family's farm and ranch, and I managed our family's cattle ranch for 2 years following my uncle's death in a farming accident. I love the cattle business, but I also know firsthand the inherent business risk associated with working in that business. I believe I also understand the concerns producers have about the changing structure of U.S. agriculture, especially in regard to packer concentration.

In 1999, a colleague, Lynn Hunnicutt, and I entered into a cooperative research agreement with USDA, GIPSA. This agreement gave us access to a confidential data set which reported all of the individual transactions for 4 beef packers in a single major beef production area of the country over a 15-month period during the mid-1990's. The data included information on packer purchases from over 300 feedlots during the study period. The purpose of our research was to examine the effect of transactions costs on the stability of packer-feedlot relationships.

In a competitive cash market, both packers and feedlot operators should theoretically have choices about when and with whom transactions take place. If relationships within cash markets are found to be rigid—that is that market participants tend to have exclusive relationships with each other over time—then several possible economic reasons might explain this behavior.

One possible explanation for rigid exclusive business relationships might be that packers simply exercise control over feedlots by somehow dictating the terms under which transactions take place. Another possible explanation for exclusivity is that all feedlots offer about the same price for cattle of the same quality, but that some feedlots and packers simply are able to conduct business at a lower cost than they would if they dealt with other feedlots and packers. In other words, exclusivity may benefit both packers and feedlot operators because transactions costs are minimized by doing so.

The final possibility is that exclusivity expresses itself because one packer simply consistently offers a higher price to a feedlot operator for his or her cattle, and as a result the feedlot consistently sells to that packer. Economic theory suggests, however, that if

large firms compete vigorously with each other that their market shares will be unstable.

We used a spatial statistic in our research and we conducted two tests. Our first test was less restrictive than the second and found that, depending on the definition for our spatial statistic, the majority of feedlots, between 59 to 86 percent, sold primarily to just one packer or primary buyer.

A few feedlots had two primary buyers, but almost none of the feedlots had three primary buyers.

Our second test determined if feedlots tended to sell all of their cattle only to primary buyers. We broke the data into two-week time periods, which is a typical planning horizon between when cattle are purchased and eventually processed, to determine if feedlot operators tended to switch between packers from time to time.

We found that when feedlot operators sold cattle, they almost always sold all of their cattle to their primary buyers. For example, for all transactions both cash and contract during the study period, feedlots sold only to their primary buyers 80 percent of the time. This means that if the feedlot operator offered cattle for sale during 10 of the two-week periods, he or she sold cattle on the average to the primary buyer or their primary buyers in 8 of those 10 periods.

Most feedlots sold only to their primary buyers in all cases, since the median percentage of periods when transactions were only with the primary customers was 100 percent. This suggests that feedlots did little switching from their primary buyers during the study period, and indicates that exclusive and very stable relationships existed between feedlots and packers during this 15-month period.

We tested the reasons for why exclusive, stable relationships existed between these feedlots and packers using regression analysis. We found that the level of previous dealings between a feedlot and a packer significantly influenced the proportion of cattle the feedlot operators sold to that same packer in the current time period.

Also, downward adjustments in the proportion of cattle sold by a feedlot to an individual packer were larger than upward adjustments, but were done only infrequently, actually in only about 5 percent of the possible cases. This suggests that once a business relationship has been established between a feedlot and a packer that that relationship is more likely to continue in the future than it would if no previous relationship existed.

It also suggests that feedlots frequently make incremental upward adjustments in the proportion of cattle they sell to a primary buyer, but that downward adjustments are made infrequently. Our results indicate that previous proportions used as a proxy for all transactions costs and the presence of a contracting relationship between feedlot and packer all influence the proportion of sales between the feedlot and packer.

Other proxies for transactions costs, such as feedlot size and market volume, were not shown to have a statistically significant influence on the proportion of sales from a feedlot to a packer. Unfortunately, we had only information about successful bids for cattle and not all the bids that were placed on cattle. As a result, we could test for adjustments in the proportion sold only by using the average price packers paid for a base type of cattle, and the base was choice yield grade 3 steers.

Although the sign for the test was positive, as expected, indicating that as a packer with a higher price was present that some adjustment was made, the test could not yield a reliable conclusion, since the parameter estimate was not statistically significant.

The results of our analysis suggest that relationships between packers and feedlots can be understood at least in part through transaction costs. Consequently, these relationships may be mutually beneficial to both packers and feedlots. Perhaps the most important finding of our research is the fact that it is necessary to incorporate transaction costs into economic models that are looking at this industry.

Thank you.

[The prepared statement of Mr. Bailey appears as a submission for the record.]

Senator CRAIG. Doctor, thank you very much.

Now, let us turn to Dr. Cotterill.

STATEMENT OF RONALD W. COTTERILL, PROFESSOR OF AGRICULTURAL AND RESOURCE ECONOMICS, UNIVERSITY OF CONNECTICUT, STORRS, CONNECTICUT

Mr. COTTERILL. Well, Mr. Chairman, my coauthors, Adam Rabinowitz and Li Tian, who are with me here in the room, and I would like to thank the Committee for the opportunity to share our research with you today.

Milk prices are cyclical, but recently we have seen an extended 20-month milk price depression. Moreover, dairy farmers in the Northeast have been the victims of what I will term a pincer movement in policy during that period.

The first pincer is that Federal milk market orders have been relaxed to allow competitive market forces to set fluid milk prices. On the face of it, this sounds positive. But the second pincer has been that mergers have transformed the region's processing and retailing markets so that we no longer have competitive market forces. Stop and Shop, the region's leading supermarket chain, is now a dominant firm in most local retail markets in southern New England. Dean Foods is now our dominant fluid milk processor.

Antitrust enforcement has been active, as we have heard today. However, it has clearly been inadequate. I know the track record on a firsthand basis because I have been involved as economic expert for the region's State attorneys general in two of these key enforcement actions and several others in the greater Northeast. We have tried, and failed, to stem the rise to dominance in both sectors. Subsequently, there has been an increase in market power, a subject that I now turn to.

Figure 5 in our written testimony summarizes our findings on milk channel pricing in New England. In June 2003, farmers received $1.03 per gallon for raw milk bottled. Processors collected an additional $.60 for the wholesale price of milk. So the wholesale price for milk delivered into supermarket coolers was $1.63 per gallon.

Now, the region's top four retailers charge more than $3.07 for that milk. This means they captured $1.45 per gallon for in-store cost and profits. Our research at Pennsylvania State and the University of Maine indicate that store handling costs are, at most,

$.40 per gallon in these large supermarkets. So that means their bottom-line profits are $1.00 per gallon or more. That is after all costs are accounted for.

Based on similar repeated surveys, we conclude that during the farm milk price depression, New England supermarket chains' bottom-line profits per gallon were equal to or higher than the price that farmers actually received for that very same milk.

Now, think about that for a moment. The bottom-line net profits at the supermarket level are higher than the price that the farmer receives for his labor and all his inputs and his effort to sell that milk to the processor. We submit that this is economically inefficient milk pricing, as well as unfair milk pricing by almost any standard of fairness.

The source of this excessive retail margin during the milk price depression in the Northeast was primarily low farm milk prices, not higher retail prices, and I will have more to say on that in a moment. Large supermarket chains now deal from a position of power when negotiating wholesale milk prices. Processors thus have to deal in a similar fashion with farmers and their cooperatives. Consequently, farm milk prices in the Northeast are lower than they would be in a competitive market channel.

How low? Well, if you look at July, Northeast dairy farmers received at the mailbox $11.63 per hundredweight. In Wisconsin, which by the admission of the economists at the University of Wisconsin is an effectively competitive raw milk market, farmers received $12.26 per hundredweight in July.

Now, let's think of spatial markets in milk for a moment. If, in fact, the Northeast milk market were competitive, milk prices there would be higher, not lower, than those in Wisconsin. They should be higher by at least the amount of the cost to transport milk or milk products from Wisconsin to the Northeast. And I repeat milk prices in the Northeast were lower, not higher, than in the supply basin of the upper Midwest.

Milk prices in the Northeast, absent the exercise of market power against the region's farmers, could very well be $14 per hundredweight or higher at the farm level. Our analysis also suggests that if the Northeast becomes milk-deficient and must haul milk from the Midwest, Northeast consumers will pay higher prices than they would from an indigenous milk industry.

But what can we do about this? Policy options include the following. I will give the standard shibboleth of more vigorous antitrust enforcement, especially against the currently active Hood/NDH merger. That is a horizontal merger with the Crowley plants in Albany, New York, and Concord, New Hampshire. These plants compete with Hood and others in New England. It should simply be stopped. End of case. Simply don't allow it.

A second approach would be a strengthening of the Federal milk market orders by elevating the Class I differential in monopsonistic markets to protect farmers from low prices. After all, one of the original reasons for establishing milk market orders was to protect farmers from monopsonistic pricing by channel firms. I think we have forgotten that over the last 10 years in our agricultural policy area.

Alternatively, States in the Northeast must consider policies that address monopsonistic pricing. Effectively, we are beginning to give up on the Federal solution. At the University of Connecticut, we have developed a price collar policy that can lower consumer prices and elevate farm prices without imposing price ceilings or explicit price controls.

Price collars change the incentive structure of the market channel. Profit-maximizing behavior leads to prices that eliminate most of the excessive channel profit margin. However, firms still earn profits. It is not confiscatory of basic profitability.

Price collars also raise farm prices and lower consumer prices during milk price depressions such as the one we have recently experienced. In the current environment where farm prices are relatively high, they really would not be binding on the farm side, but they would be binding, as the New York price gouging law is on the consumer side.

Finally, I would suggest a couple of more general observations on this area. Public empirical research by university economists is shrinking up because we simply do not have access to the relevant economic data. The Justice Department gets such data in merger investigations, but often it is confidential and they can't reveal it and they can't publish research on what they see.

At the University of Connecticut, over the last 10 years we have spent over $200,000 buying scanner data by hook and crook from the Information Resources, Inc. company. I have quietly talked with one person or another over those years and basically bought the data with no constraints.

Recently, IRI has finally shut the door on me, after being burned three times, and now they have negotiated a very explicit policy toward universities. The University of Wisconsin recently bought scanner data. They can't reveal the name of the market that the data is for, they can't reveal the name of the firm that the data is for, and they can't even reveal the name of the brand that the data are for. They also have to get approval from IRI for the publishing of their research results. I would submit that this constraint on access to data by public economists, in fact, is a serious problem.

Finally, I would say that in antitrust policy there is a serious gap between merger enforcement and Sherman Act enforcement. Any merger that raises prices is illegal, basically, if we are talking about a monopoly, or if it lowers prices if it is a monopsony. And we often apply that, but people get through the slats.

The Sherman Act monopolization standard is so far removed from what we see in this consciously parallel pricing by oligopolists and oligopsonists that, in fact, we really can't get at these companies with the current antitrust laws. So we need to address either tighter merger enforcement or a rethinking of the underlying laws, or we have to go to external regulation rather than antitrust in some of these market areas.

That concludes my testimony.

[The prepared statement of Mr. Cotterill appears as a submission for the record.]

Senator CRAIG. Doctor, thank you very much.

We have about 5 minutes left in a vote, so I am going to once again—I am sorry, Professor—recess the Committee. I will hustle, vote, and be right back.

Mr. CARSTENSEN. I picked a late plane to go home on tonight.

Senator CRAIG. You are very fortunate.

Thank you.

[The Committee stood in recess from 4:10 p.m. to 4:27 p.m.]

Senator CRAIG. The Committee will reconvene. Thank you all again for your patience.

Let us turn to Professor Peter Carstensen, from the University of Wisconsin at Madison. Thank you.

STATEMENT OF PETER C. CARSTENSEN, GEORGE H. YOUNG-BASCOM PROFESSOR OF LAW, UNIVERSITY OF WISCONSIN LAW SCHOOL, MADISON, WISCONSIN

Mr. CARSTENSEN. Thank you, Senator. The advantage of the break was that my name tag has now been correctly spelled, so there was some benefit from that.

I am honored to be asked to offer my views on the problems confronting farmers and ranchers in selling their products. The focus of this hearing is on the monopsonistic character of those markets and the potential for law, both antitrust law and market-specific regulation, to restore open and competitive markets. I would like to summarize my fairly extensive written statement in about six points, if I may.

First, farmers are poorly served by the existing market structures and practices. They confront excessive concentration in agricultural product markets that create strong inducements to engage in unfair and discriminatory practices.

Second, there is clear evidence of abuse of the resulting buying power, manipulation of public market prices to drive down the private transactional prices, direct exploitation of sellers by low prices, discrimination that denies equal access to the market, and imposition of other unfair and exploitative conditions such as compulsory arbitration.

Third, I think the harder problem which we have been talking about today is how to restore fair, open, equitable, and accessible markets. If there are unconcentrated markets, there is a strong tendency to achieve those kinds of methods naturally through the market process. Where they lack those inherent tendencies, where there is concentration, where there is unequal informational power, then we have the problem in the market. But law can play a very important role in reducing the capacity to engage in strategic conduct and restore the balance between the parties. This is market facilitation; it is not replacement of the market. We have two legal systems that are relevant here—antitrust law and market facilitation-type regulation.

My fourth point: Antitrust law should and can make an important contribution. However, I think antitrust enforcers have failed in two respects. First, and most importantly, they do not appreciate the differences between monopsonistic buying power issues and more familiar seller power issues.

We heard the Assistant Attorney General start off by saying that monopsony is the mirror image of monopoly. You will notice that

after the first recess when he came back, he began to qualify that statement and acknowledged that maybe there were some differences and they needed to be studied more. It is an important recognition on his part.

Secondly, they need to develop relevant enforcement policies that focus on the problems of monopsonistic power. The failure to do this, I think, has resulted in a great weakening of the potential for antitrust enforcement.

I suggest that there are four things that this Committee should focus on in terms of antitrust enforcement policy and law: first, the need to develop express buyer power guidelines for both merger and restraint of trade analysis. I have elaborated on some of the theoretical bases for that kind of separate focus, separate analysis, because it is not a mirror image.

Secondly, as a number of you have emphasized, we need more active enforcement of our current law against mergers and conduct creating anticompetitive risks—the Farmland/Smithfield transaction. We have got areas of recurring collusion. We have got areas of monopoly power that are known to the Justice Department. My reaction to some of the Assistant Attorney General's comments is, in summary, listening is not enough. They have the resources, they have the capacity. They need to be out doing active investigation.

Third, we need greater transparency concerning the decisions to enforce or not to enforce. Today, I learned a little bit more about why they might not have taken action in Farmland. They have never made a public statement about that. A little bit more about what they were trying to do in Suiza-Dean—they have never made anything more than the most generalized kinds of statements about that transaction.

I am very pleased with what I understand to be the proposal from Senator Kohl and Senator DeWine on various antitrust reforms that focus in on strengthening the Tunney Act, another place which will compel some greater transparency and disclosure. I think that is a very important proposal.

Finally, I think that we really need to reconsider the judicially imposed limit on those who indirectly are injured by antitrust violations having the ability to bring lawsuits. Specifically, Wisconsin farmers were the victims of price manipulation in the cheese market, but they were only indirectly injured. They had no remedy under Federal law and they were unable to get remedy under State law.

Nonetheless, all this said, antitrust law has inherent limits. I think that is the best way to put it. We need to have other sources of legal control. We have some now in the Packers and Stockyards Act and the Agricultural Fair Practices Act. These are not very well-developed areas of law. Worse, the Secretary of Agriculture under both political parties, I must say, has failed to use the power to make rules and regulations that could have facilitated fair and open practices at least in some markets, especially livestock markets.

In my paper, I have suggested that there is an idealized kind of elaborate statutory system that ought to facilitate agricultural markets. Realistically, I think there are two presently pending proposals that deserve your attention and support.

Senators Grassley and Feingold—and they have already referenced this in their statements—have S. 91 that would prohibit arbitration clauses in livestock supply contracts. The biggest problem is it (S. 91) doesn't apply in any other agricultural contract.

Senator Enzi and others have proposed S. 1044 that would impose market-facilitating regulation on the use of supply contracts, again limited to livestock markets. It should be much more general. If we are going to have forward-looking contracts, they need to be subject to a legal regime.

In sum, monopsony power in agriculture is a growing threat to the operation of agricultural product markets. It is vital that the law be used both to limit the growth of this power and to regulate its use. Both consumers and producers will be better off if both antitrust law and market-specific regulation are directed at the problems that have arisen in this area.

It is my hope that members of this Committee will use their influence both to bring about legislative change and to insist on more active and effective enforcement of the existing laws that address these problems.

Thank you.

[The prepared statement of Mr. Carstensen appears as a submission for the record.]

Senator CRAIG. Professor, thank you very much for that testimony.

Senator Kohl, questions of the panel?

Senator KOHL. I think your testimony in all three cases has been really good and informative and enlightening. My conclusion, listening to you all, particularly you, Mr. Carstensen, is that if we are going to do something effective about monopsony, it takes the Federal Government, whether it is the Justice Department or the Congress, to step in and take a look at it all and come up with new ideas, new thoughts, new rules, new regulations, new oversight, new legal action or additional legal action to correct what I believe you are all saying is a situation that is not good either for the producers or for consumers and needs to be improved, as I said, at the hand of the Government, as it is expressed through the Justice Department and through the legislature.

Mr. Carstensen, are you saying that?

Mr. CARSTENSEN. Yes, very much so. Professor Cotterill made the point about the need for better data. There is a lot of information that exists which unfortunately scholars can't get access to, so that it makes it much harder to develop and to prove the kinds of intuitions that we have about how competition is harmed in the markets.

Again, the Federal Government through the power of the Federal Trade Commission and the Department of Agriculture to collect data can be very helpful as part of that process of developing better theories and then employing them effectively through legislation and through enforcement.

Senator KOHL. Mr. Cotterill, what is your observation with respect to what I said?

Mr. COTTERILL. I think that you are entirely accurate, sir. I applaud your idea that the Federal Government has a role to play in

our agricultural markets. It is something I learned at the University of Wisconsin as a student 30 years ago.

The University of Wisconsin has been a strong player over the last 100 years in defining markets, defining the rules that create markets, and defining antitrust policies. I applaud all of that.

However, I am also to the point where I am beginning to think that it is difficult at the Federal level to make that progress, and I am almost becoming a fan of Antonin Scalia, of the Supreme Court, that the States also should be empowered to deal with industrial policy questions that affect their citizens. I know that is a very difficult area, as you are well aware of as well. So I think we will see progress in both areas, hopefully.

Senator KOHL. Dr. DeeVon Bailey?

Mr. BAILEY. Yes, Senator. I believe my feelings are somewhat less pronounced, I guess would be the way that I would state that. I believe, for one thing, that the food system has been a great success story in the United States, that we have all types of different food and many, many different varieties that actually in real terms is less in price for consumers today than it was 10 or 15 years ago.

So I am not as strong in my opinions as far as whether consumers have been injured in some way. That doesn't mean that they haven't been for sure. The possibility exists that perhaps some market power has injured consumers. But if you look just on the surface of things, you have to applaud what agribusiness has been able to accomplish in this country.

On the producer side, there have been questions for many, many years. Actually, these same kinds of discussions were taking place at the turn of the 20th century, too, within Congress and also out in the country. People were concerned about the power exercised by processors. So I think it has been a topic that we have discussed for a long time.

It maybe is a more important topic than usual at this point because of the increased influence of the retailers and the power that they are exerting on the market, or potential power that they are exerting on the market right now. So I agree that it is an important issue.

I also agree with the other two panelists that data really is the issue. Without cost data, for instance, it is very, very difficult to come up with a definitive answer regarding whether market power exists or monopsony power exists in these markets.

Senator KOHL. Mr. Chairman.

Senator CRAIG. Herb, thank you.

Gentlemen, thank you for your response to those questions. Both Senator Kohl and I were visiting on the way over from that vote talking about the dynamics of that market out there and what we might do about it in a way that continues to keep a viable market, and certainly a market that the consumer and producer benefit from.

I think you are right, Dr. Bailey. There is no question that if you walk into any supermarket today in this country versus the rest of the world, that demonstration of supply and variety of supply and cost has to be an amazing success story.

On the other side are my producers in Idaho and in the Cash Valley who have not recognized true return on investment of any

magnitude that justifies reinvestment in a long while. I grow increasingly concerned about the ability of the producer side of agriculture to capitalize itself unless they enter into contracts with processor distributors that may not be in their best interest in the long run, and yet that appears to be the situation.

Gentlemen, you watch these markets closely. All of you peer into your crystal ball in a moment and tell me what you see as the trend line and the effect. I can look backward. I probably have a more difficult time looking forward.

Dr. Bailey, would you start?

Mr. BAILEY. I believe without question that the trend line is toward more contracting, closer relationships in these markets. What we have seen prior to the last few years is closer relationships between farmers and packers, mostly through contracting, and that trend continues.

But perhaps even the more important phenomenon that is occurring in the market now is closer relationships between retailers and processors to the farmer. I think that if I had to choose one trend that I see in food markets during the next decade, it is more closely specified types of food products beginning at the retail down to the farm level.

So that would suggest an even greater pressure to perform on the part of farmers to specifications that are dictated at some place above them in the channel. Probably the only way to avoid that is some sort of intervention, but one also has to ask the question, is that the right choice; would consumers actually support that kind of intervention, because they are likely the ones that will end up paying higher prices for food as a result.

Certainly, from the argument of fairness, there are concerns. As I said, I grew up on a farm. I know the struggles that farmers face, but we are on the horns of a dilemma in many ways in this regard. How do we keep food costs low, provide high-quality food products to consumers, but yet make sure that farmers can make a decent living?

Senator CRAIG. If I go to Safeway today, I am going to buy only Angus beef, or at least be led to buy only Angus beef. So some of that type of quality or consolidation for the retail purpose, the shaping of a product, is very much at hand.

Dr. Cotterill, would you respond to my broader question that relates to trend lines and impact on both consumer and producer?

Mr. COTTERILL. Well, Professor Bailey has given the stock answer from the agricultural economics profession. I mean, it is the consensus view. The St. Louis Fed program and others all see this increasing integration.

I am going to give you a different view. I think that unless something is done either through policies at the Federal or the State level—and it starts with data, it starts with supporting research on the externalities of these systems—Professor Bailey's prediction will be the winner. But there are substantial externalities in this system the way it is currently put together.

There was a recent article in the New York Times Sunday Magazine on the amount of fat on Americans today, and attempting to link it perhaps in an unscientific fashion to the structure of our

food system and the nature of the way we deliver products to people.

I think there is a link. It may not be proved perfectly well, although 25 years ago at the University of Wisconsin Professor Bruce Marion did a study that correlated the amount of fat on people to the kind of diet and concentration in certain industries. So it has been done. I think that is an externality that we need to deal with.

Another externality is the environmental and the cultural and the social aspects of rural America. I was skiing in Switzerland this winter and within 150 yards of the condo in the Swiss Alps were three dairy farmers, each with about 25 brown Swiss cows. The machinery that they used to cut the hay on the Alps looked like gators that you see on golf courses, these tiny little machines that they run around up there. I said how in the world can you justify that kind of a dairy industry in Switzerland? Well, the spillovers to keeping the Alps brush-free, to keep the mountain meadows the way they are, are there.

This summer, I drove through northern Vermont on my way to the Montreal ag econ meetings and I took a swing out through Fairfax, Vermont, and others, and stopped at some of the rural communities with churches and some of the events that were going on. Just for me personally, to have those kinds of communities—it is like Richland Center, Wisconsin. That is a treasure; that is an asset for this country, in general.

So I think that you have to come to ways to recognize that, and I think the Europeans—we malign them for many of their programs, but with all due respect, I think that if we want a particular kind of rural America, we are going to have to do something like that. So that is the other side of what Professor Bailey gave you.

Senator CRAIG. Well, I don't dispute there is another side. My biases are clear. My wife just retired as a dietician with the National Dairy Council. When we begin to talk about fat and food, we have also got to talk about reinstating mandatory recreation and mandatory exercise with our grade school kids at the school level, which they don't like today, and a rather, shall I say, sit-on-your-backside society.

So there is a combination of things that have to occur, I think, if we are going to look at regulations that determine how much fat you can consume in a day or standards in that area. "Buyer Beware" is a significant approach, I do believe, in the marketplace if, in fact, it is a balanced one and it balances out.

Dr. Carstensen?

Mr. CARSTENSEN. Professor; I am not a doctor.

Senator CRAIG. All right, professor, thank you.

Mr. CARSTENSEN. My daughter has just gotten her M.D. degree, so she is the Dr. Carstensen in our family.

Senator CRAIG. Well, in that relationship, then, you had better maintain it.

Mr. CARSTENSEN. Right, right.

I think one of the things to bear in mind is that there is usually more than one road to accomplishing desirable economic and social objectives. If we don't do things to structure the fundamentals of how agricultural markets operate, then the contracting, that which

I have characterized as the serf-like status for farmers is very likely to emerge because there won't be any other legal structure in hand.

We had a hearing back about a year ago before the Senate Ag Committee where Professor Koontz from Colorado State talked about the things the Department of Agriculture could do much more proactively to develop standards, to develop criteria, certification systems, that would facilitate providing a greater variety and specification of agricultural products without having to go through the contractual system.

Contract is the default system. It requires—and this goes back to something that Senator Kohl said—it requires positive government action to construct a workable transactional market. That isn't going to happen naturally because it is not in the interests of many of the economic players.

So it seems to me again this is where one really needs to stand back and say here is the path that we are going to go down if we don't do anything. Are there ways to redefine that path, to preserve a number of the things that Ron Cotterill has spoken about, while still maintaining efficiency in the system?

Again, my view is there are, and we know from past experience there are, many ways to achieve efficient, desirable consequences in terms of the end product, the inexpensive food in the store. Let's look for ways that are going to preserve farms, that are going to preserve freedom of choice for farmers, because otherwise you are going to wind up with, as I say, a serf-like situation where those contracts are going to require an enormous regulatory system of their own.

It is not going to be transaction cost-free. Again, the externalities will be there. The kinds of problems in the rural countryside, the kinds of environmental problems that will result from the restructuring of agriculture will be there. You are going to have to deal with them and you are going to look at them as costs of welfare or costs of pollution. They are costs to the food system and I think better designed relationships are going to avoid a lot of those costs so that the net social cost will be lower even if the price of the food may be a penny or two higher because we use a system that is more farmer-friendly.

Senator CRAIG. Well, gentlemen, you challenge us and we are glad you did.

Senator KOHL. Mr. Chairman?

Senator CRAIG. Yes, Senator Kohl.

Senator KOHL. We have not injected into this conversation, and perhaps we won't today, but the Federal Government is providing enormous assistance to farmers in our country. I think the stats are that about half of farm income today comes from the Federal Government, and that is because what the farmers are getting from their buyers is insufficient.

So we are giving them back tax dollars to keep them in business because we want to keep the rural economy there and we want to keep our farming sector alive. If we pull the plug, that would be a disaster. You know, we would have to have hearing upon hearing and laws upon laws, and redo the whole terrain of our rural areas

in America if we pulled the Federal plug on assistance. Half of them would go out of business within a month or two.

So there is that that we need to understand, that it is not a self-regulating mechanism that is going on right now. It is a Government subsidization system, which I have voted for. I am not suggesting we should pull the plug, but we haven't figured out what to do.

Dr. Bailey, do you have a thought on that?

Mr. BAILEY. Actually, I think my colleagues were being a little bit hard on me.

Mr. COTTERILL. Oh, no. You represent the whole profession, sir.

Senator KOHL. Would you suggest that perhaps we should pull the plug?

Mr. BAILEY. No, no, absolutely not. I think that there are externalities associated with having a viable farming community in rural areas in virtually every State. Farms maintain open space. They are stewards to the land. There are many, many positive externalities that are occurring as a result of farming.

I also believe that much of the innovation especially in the meat industry is not coming at this point from the large processors. It is coming from small firms that are trying to find niches and trying to develop products that address consumer needs which the processors in many respects have not done as good a job as they could have in the past.

So I think that the Government does need to view farming beyond simply the food that is produced by farming, that there are other very positive things that occur because of farming. But also it is important, I think, to maintain an environment where innovation can occur in these industries.

Actually, there are a lot of innovative things that are taking place in small-scale farming now. We should not ignore that and should try to foster it, and I think that that is one way, along with the money that is going into commodity programs, that possibly we can help to revitalize some of the farming activities that are occurring in the country.

Mr. COTTERILL. I am fascinated that you bring up the issue of subsidies because that is something that has concerned me, because I think that with the Freedom to Farm Act back in 1995 or 1996, it was actually a victory for agribusiness rather than farmers.

Farmers were sold a bill of goods on that one because, yes, we are spending billions of dollars to keep our farmers in business. But having said that, they really are constrained by the Government just as they were constrained by the supply control that they didn't like prior to this; as a matter of fact, maybe more so now than then.

The real benefits of those low prices haven't always been passed on to consumers. In a non-competitive market channel, the market power does mean that some of those lower raw prices stay with the agribusiness firms. In a competitive channel, you get it passed on. In non-competitive, you don't.

So you have a whole new lobbying game here in Washington where you have the agribusiness processors and the retailers. They like this program. I am not so sure it benefits farmers, but there

is a complication to it as well because this program in many ways is driven by the idea of global trade and the idea that, in fact, America's farmers are going to compete in a global market. Therefore, we can't go back to the old supply control programs and the higher market prices that we had.

I am not so sure that is true. If you look in some of our industries like dairy. I am not so sure that you couldn't go back to some of the supply control, get some of these market prices a little higher and save the Government billions of dollars. I think we have to reconsider supply control in our agricultural markets, like we had for about 50 years before 1995. But I am not an agricultural policy economist, so you probably might get a stronger answer on the other side from some of them. But that is my perspective on it.

Mr. CARSTENSEN. I will just chime in that the subsidy issue creates again a set of distorted incentives in the market process and it requires, as you start fiddling with this system, thinking through fairly carefully how the subsidy incentives play off against the contracting incentives, the other ways that we can interfere in the market. It doesn't make your jobs any easier, I am sorry to say.

Senator KOHL. Thank you, Mr. Chairman.

Senator CRAIG. Well, gentlemen, we wish we could continue this. I have enjoyed not only your testimony, but the conversation. I think it is increasingly valuable. I think that one of the reasons this hearing is being held is the frustration that we are all sensing on our own part as it relates to policy and how that contains and retains a balance that allows profitability at the production level and the pass-through and reasonable prices and high quality to the consumer.

Certainly, in my State there is really no segment of my agriculture that hasn't gone untouched by fairly extensive periods of less than profitability. I have looked at the staying power of that industry and its equities versus its debt structure. If you look at and parallel that, you see a substantial problem growing out there today that at some point is going to get spoken to.

Gentlemen, we thank you. I will say in closing this hearing that the record will remain open for 7 days for any written submissions, and there will be some questions coming your way and we will thank you for your response to those. Again, we thank you all for being here.

The Committee will stand adjourned.

[Whereupon, at 4:59 p.m., the Committee was adjourned.]

[Question and answers and submissions for the record follow.]

[Additional material is being retained in the Committee files.]

QUESTIONS AND ANSWERS

U.S. Department of Justice

Office of Legislative Affairs

Office of the Assistant Attorney General

Washington, D.C. 20530

March 25, 2004

The Honorable Orrin G. Hatch
Chairman
Committee on the Judiciary
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

Attached are the responses to follow-up questions submitted to Mr. R. Hewitt Pate, Assistant Attorney General, Antitrust Division, U.S. Department of Justice, following the October 30, 2003, hearing on "Monopsony Issues in Agriculture: Buying Power of Processors in Our Nation's Agricultural Markets." Please do not hesitate to contact this office if we may be of further assistance.

Sincerely,

William E. Moschella

William E. Moschella
Assistant Attorney General

cc: The Honorable Patrick J. Leahy
Ranking Member

Answers to Questions for the Record
Hearing on Monopsony Issues in Agriculture
Senate Committee on the Judiciary
October 30, 2003

Questions from Senator Grassley

Question 1: During the hearing, you stated that DOJ does have specific guidelines to determine the competitive impact of a monopsony in agriculture. Please provide me with a copy of the specific guidelines that you would use to evaluate a potential monopsony.

> **Answer:** We analyze potential anticompetitive exercise of market power on the buyer side in the same manner as on the seller side. They are the mirror image of one another. For mergers, our starting point is the Department of Justice/Federal Trade Commission Horizontal Merger Guidelines. Similar analysis goes into evaluating joint ventures and other collaborative conduct. Monopolization or attempted monopolization would also be analyzed in similar fashion on the buyer as on the seller side. Antitrust analysis requires a careful case-by-case evaluation of the particular facts regarding the market and conduct involved.

Question2: Do you believe it could be beneficial to perform an analysis after a merger or acquisition, previously under review by DOJ, to determine whether action or inaction by the Department preserved competition?

> **Answer:** It could be beneficial to perform such studies in those limited circumstances when we have a high degree of confidence that we could reach sufficiently accurate conclusions, although it should be noted that such studies would be likely to consume significant time and resources that otherwise could be spent on enforcement. As a law enforcement agency, we generally focus our resources on pending matters, and our compulsory process powers are focused on determining whether a violation of law exists. From time to time, in undertaking a new investigation or enforcement action in the same market or a related market, we do have an opportunity to assess competitive conditions as they developed subsequent to previous mergers. If there are retrospective studies on

The Honorable Orrin G. Hatch
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> the competitive effects of a merger or enforcement action, we would certainly take them into account as appropriate in our approach to particular mergers and in our merger enforcement policy. I would also note that the Department and the FTC jointly held a merger workshop in February 2004 to study our merger enforcement.

Question 3: Please provide me with the criteria you would look at when considering an agriculture merger between packers (like the Smithfield/Farmland acquisition). Please list the potential monopsonistic criteria that would be considered.

> **Answer:** I can respond to your general inquiry about mergers between packers. This answer does not address the specific Smithfield/Farmland matter from which I was recused. In all merger matters, we would look at all markets involved in order to assess whether the merger was likely to substantially lessen competition in any of them. In mergers between packers, the principal markets of potential concern would be the procurement markets for the livestock in question. These markets could be defined as regional or local, depending on our conclusion in the particular case as to how far a livestock producer could economically travel or ship in order to get competitive prices for the livestock to be sold. We would look at each of those markets to assess whether the proposed merger, and the consequent reduction by one in the number of competing packers in that market, would be likely to so reduce competition among the remaining packers as to enable them to depress the prices they offer for livestock below competitive levels.

Questions from Senator Leahy

Question 1: Mr. Pate, I wrote to you in December of last year to oppose the proposed merger between H.P. Hood Incorporated and National Dairy Holdings, a dairy processing company largely owned by the Dairy Farmers of America. This merger would have created the second-largest milk processing company in the country. More importantly, the merger would have allowed the Dairy Farmers of America Cooperative to control more than 90 percent of the New England fluid milk supply through exclusive supply arrangements with both Dean Foods and Hood Milk. The merger was a prime example of the trend towards greater vertical integration within agriculture markets. By controlling

both the cooperatives and the processing facilities, these consolidations allow a single market actor to hold down the wholesale price of commodities like milk, while raising retail prices. Both the farmers and the consumers lose out.

The Department of Justice did launch an investigation of the proposed merger, and then in May, H.P. Hood and National Dairy Holdings announced that they would restructure their merger and eliminate the exclusive supply arrangement with the Dairy Farmers of America. At your confirmation hearing, when we were discussing this merger, you said that "in order for farmers to have a fair market in which to sell their milk, there needs to be a choice of potential purchasers." I wholeheartedly agree, and so would the dairy farmers of Vermont. At the monopsony hearing, you testified that "agriculture has a structure that makes so-called monopsony concerns more likely to arise . . . because the industry is characterized by many smaller producers selling to fewer and larger processors." Can you assure me that the Department of Justice will work to block mergers that do harm to farmgate milk prices by limiting the number of producers to whom farmers can sell their product?

> **<u>Answer</u>:** You may be assured that the Department would challenge a merger that we concluded would lower farmgate milk prices because of a reduction in competition in violation of Section 7 of the Clayton Act. The Antitrust Division remains active in examining the proposed merger between H.D. Hood and NDH, and monitors the competitive situation in the dairy industry generally. The Department shares your concern that mergers not reduce competition in this important industry, and will take whatever enforcement action may be warranted to protect competition there.

<u>Question 2</u>: As I understand it, the Justice Department and the FTC divide antitrust cases on the basis of an informal agreement, and the DOJ investigates the milk processing industry, while the FTC investigates retail milk issues. So the FTC has the primary responsibility for scrutinizing milk prices as they affect the consumers, and the DOJ has the primary responsibility of pursuing these cases as they impact dairy farmers. But if processors lower the prices at which they buy milk, but do not pass on those costs savings to consumers, then they are just pocketing the extra profits to the detriment of <u>both</u> consumers and farmers. The DOJ and the FTC are looking at two sides of the same coin, and there must be overlap between their investigations. What have the FTC and Department of

Justice done to cooperate on these cases? Are there further steps that need to be taken to enhance both agencies' effectiveness in these areas?

> **Answer:** Under the process developed by the Department of Justice and the Federal Trade Commission for allocating enforcement responsibility between the agencies according to which agency has the most recent and extensive experience in the particular markets involved, the Department has investigated matters and brought enforcement actions involving retail milk markets as well as wholesale and manufacturing. The FTC and DOJ do cooperate closely in antitrust matters and will continue to do so in the future.

Question 3: You mentioned in your written testimony that in some instances industry-specific rules provide additional regulation beyond existing antitrust laws. In your opinion, are current antitrust laws adequate to the task of ensuring that agricultural processors cannot abuse their buying power to the detriment of farmers? Do you have any recommendations to Congress for changing the existing antitrust laws to better arm the Department of Justice in these cases?

> **Answer:** I believe that the existing antitrust laws are adequate to the task of ensuring that agricultural processors cannot abuse their buying power to the detriment of competition vis-a-vis producers through coordination with other processors, through monopolizing any processing market, or through merger or acquisition. If Congress concludes that additional protections for producers are warranted, those additional protections are appropriately provided through avenues outside the antitrust laws.

Question 4: Dairy is not the only commodity where consolidation at the processor level has been a major issue. Serious concerns have also been raised in the poultry and livestock markets. The processors, however, seem unconcerned about the farmers who produce these products. Last year at a hearing before this Committee, the American Meat Institute actually called for even more vertical integration in agriculture markets. In the last Congress, I joined Senator Daschle and others in introducing a bill that would broaden the authority of the Packers and Stockyards Act to restrict the anti-competitive activities that these processors have used routinely to drive down commodity prices. Can I have your assurance that you will work with your colleagues in the Department of Agriculture to

scrutinize further vertical integration in these markets? Will you assist me and my colleagues in developing legislation to ensure that the Department of Justice and the Department of Agriculture can effectively police anti-competitive behavior on the part of food processors?

> **Answer:** The Department of Justice has a constructive, cooperative relationship with the Department of Agriculture on agriculture-related competition matters. We will continue to give careful scrutiny to mergers and potentially anticompetitive conduct in these markets, consulting with USDA as appropriate, including vertical integration that potentially raises antitrust issues. The Department is not aware that the Administration has stated a position on the advisability of further legislation in this area.

Question 5: One theme that emerged during your exchanges with various Senators at the monopsony hearing was that, as you testified, "agricultural markets can be different from other markets" in important ways for antitrust enforcement, from other markets, and that "farmers are rightly concerned about whether agricultural markets are remaining competitive." You said, as I mentioned in the first question above, that "agriculture has a structure that makes so-called monopsony concerns more likely to arise . . . because the industry is characterized by many smaller producers selling to fewer and larger processors." Given that you recognize that this is a sector of the economy more vulnerable to monopsony problems, why has the Antitrust Division pursued only the few cases that you mentioned in your testimony? And if Congress concludes that you are correct when you state that the agricultural sector is particularly vulnerable to seller-power problems, but that you are incorrect when you say that the Antitrust Division can be relied upon to combat those harms effectively, what legislative initiatives would be most effective in remedying that problem?

> **Answer:** The Department believes that the antitrust laws are appropriately written in their current form to address the concerns they are designed to address, including monopsony concerns. The Division has pursued monopsony cases as appropriate, including cases in the agriculture industry, when mergers would have resulted in a violation of the antitrust laws. My testimony to the effect that we have relatively fewer cases involving concerns with the buyer side of the market than cases with seller side market power is simply a factual description of the mix of cases we review, and in no way

indicates a lack of vigilance in buyer side matters when they arise. I do not have any views at this time on any legislative initiatives in agriculture that Congress may consider in the future.

Question 6: Another theme that you sounded in your testimony before the Committee was particularly troubling to me, because it suggested strongly that monopsony issues do not receive the same level of attention, the same devotion of resources, or the same benefits of experience that other competition issues do. You "agree[d] . . . that agricultural markets can be different than other markets." You stated that "farmers are rightly concerned about whether agricultural markets are remaining competitive." You recognized that the "agricultural marketplace . . . is undergoing significant change." You acknowledged that "agriculture has a structure that makes so-called monopsony concerns more likely to arise . . . because the industry is characterized by many smaller producers selling to fewer and larger processors." Yet you also candidly admitted that the Division is "more used to dealing with cases where the alleged harm is on the side of sales," that monopsony "is something we do have less experience with" and that "our economists have less experience with," that the Division has no written guidelines (as it does for monopolies, despite the differences between the two). This strikes me as a potent and troubling combination: a particularly vulnerable market sector and an admittedly inadequate amount of experience in dealing with it. Can you assure the Committee that the Division will undertake both to educate its lawyers and economists on the special issues presented by seller power cases, and that it will also undertake to draft appropriate guidelines for investigating and evaluating such cases?

Answer: My testimony to the effect that we have relatively fewer cases involving concerns with the buyer side of the market than cases with seller side market power is simply a factual description of the mix of cases we review, and in no way indicates a lack of vigilance in buyer side matters when they arise. The point I was trying to make is that situations where monopsony concerns have the potential to warrant antitrust enforcement come up much less frequently in practice, and as a result we have correspondingly less experience dealing with such situations. I can assure you that the Antitrust Division does and will continue to give monopsony concerns every bit as much attention when they arise. I would also note that we have recently announced that the Antitrust Division and

the FTC jointly will be holding a public workshop on mergers and one of the areas that the workshop will focus on is the issue of monopsony in mergers.

Question 7: You testified that substantial Antitrust Division resources, most particularly personnel, are devoted to agricultural issues. Please quantify for me, in terms of lawyer-hours and economist-hours, how much of the Division's efforts are focused on issues in the agricultural sectors of the economy. Please also indicate the proportion of those efforts that are spent on monopsony issues.

Answer: In general, we have two legal sections that are responsible for agricultural-related enforcement. There are sixty attorneys in those sections, and those sections also have other enforcement responsibilities. Also a number of economists work on agriculture issues and investigations. The resources devoted to agriculture vary considerably depending on what matters are active at any given time. Thus, holding the size and complexity of matters equal, there will be more resources devoted to agriculture issues when there are five pending mergers than when there are two pending mergers. There are several attorneys and economists at the Division who have considerable experience in agriculture-related matters accumulated over many years, and many other attorneys and economists who have worked on agriculture-related matters. Resources are devoted to issues on a case-by-case basis, according to the relevant facts regarding the markets and the conduct involved.

Question 8: I understand that the Antitrust Division does not engage in retrospective evaluations of the efficacy of its enforcement efforts, but I am concerned about the fact that inadequate restraints on anticompetitive agricultural markets will leave the remaining market players either in thrall to the processors or simply out of business. In response to a question from Senator Grassley, you said some of the Division's attorneys had information about whether divestitures had preserved competition. Could you make those attorneys available to discuss these issues with members of the Judiciary Committee or their staffs?

Answer: I indicated that attorneys and economists at the Antitrust Division keep up to date with competition-related market developments in the agriculture sector. While they could be expected to be generally aware of the current state of competition in

> markets they deal with, in any new investigation they would take a fresh look at the facts. The Antitrust Division has informally briefed Committee Members and staff on these issues in the past, and would be pleased to do so again as the interest and need arises, consistent with our role as law enforcers.

Question 9: I appreciate the fact that you are clearly taking seriously the role that the Department of Agriculture has to play in these cases, and I am particularly pleased to hear that you have instituted regular meetings with USDA staff to consider agricultural competition issues. What do these meetings entail? Are they generally for simply sharing information about what is occurring at the two agencies, or is the USDA actively involved in the investigation of cases and the decisions about appropriate remedial action?

> **Answer:** Attorneys and economists at the Antitrust Division confer frequently with counterparts at USDA, on specific investigations as well as on more general mutual concerns. In addition, we have recently instituted periodic meetings between "front office" officials at the two agencies to discuss both specific and general matters of interest. Each agency makes its own enforcement decisions in accordance with its distinct enforcement responsibilities.

Question 10: You testified that the frequent claim that "monopsony can produce anticompetitive harms at lower levels of concentration than monopoly . . . should be looked at." You said that the Division should examine the problem, "and then tailor our enforcement efforts accordingly." Please outline your plans for undertaking that study, and your expected timeline. I also hope you can assure the Committee that you will be available to discuss your findings as soon as is practicable.

> **Answer:** I would first note that the Antitrust Division and the FTC recently held a public workshop on mergers in February 2004 and one of the areas the workshop focused on was the issue of monopsony in mergers. We also examine this issue through case-by-case analysis of the specific facts in all investigations where monopsony concerns are potentially relevant. We would be happy to follow up with you or your staff in the future.

SUBMISSIONS FOR THE RECORD

October 3, 2003

The Honorable Orrin Hatch
Chairman
Committee on the Judiciary
United States Senate
Washington D.C. 20510

Dear Mr. Chairman:

In January of this year, Senators Grassley and Feingold introduced the Fair Contracts for Growers Act of 2003 (S. 91) to address abuses associated with mandatory arbitration clauses in livestock and poultry contracts. A strong bipartisan and regionally diverse group of senators has cosponsored the bill, including Sens. Enzi, Johnson, Leahy, Harkin, and Edwards. We are writing to urge your support for S. 91, and for its passage by the Judiciary Committee at the nearest possible opportunity.

It is becoming increasingly common for farmers and ranchers to be forced to sign mandatory arbitration clauses, as part of "take-it-or-leave-it" non-negotiable contracts with a large, vertically integrated processing firms. Farmers are forced to give up their basic constitutional right to a jury trial, and instead must accept an alternative dispute resolution forum that limits their rights and is often prohibitively expensive. These clauses are signed before any dispute arises, thus paving the way for unscrupulous integrators to employ practices that are unfair without fear of legal challenge by the farmer.

In recognition of these concerns, the Senate passed an amendment offered by Sens. Feingold and Grassley during the recent farm bill debate to prohibit the use of forced, mandatory arbitration clauses in livestock and poultry contracts. The amendment was passed 64 to 31, but was ultimately dropped during conference negotiations.

As the lead sponsor of the Motor Vehicle Franchise Contract Arbitration Fairness Act, you have been instrumental in bringing attention to the abusive use of mandatory arbitration clauses. The Grassley-Feingold Fair Contracts for Growers Act is nearly identical in structure to the "car dealer" arbitration bill that you ushered to enactment in 2002. Specifically, it prohibits the use of pre-dispute mandatory arbitration clauses in livestock and poultry contracts, and would require that both parties to such a contract agree in writing to pursue arbitration after the dispute arises.

Arbitration can be a useful and valuable tool when entered into in a voluntary manner by two parties. However, arbitration can be used to severely limit the rights and judicial options in a non-negotiable contract.

We look forward to working with you and other members of your committee toward passage of this important legislation.

Sincerely,

Alabama Contract Poultry Growers Association
American Farm Bureau Federation
Campaign for Contract Agriculture
Consumer Federation of America
Georgia Poultry Justice Alliance
Humane Society of the United States
National Contract Poultry Growers Association
National Farmers Union
North Carolina Contract Poultry Growers Association
Organization for Competitive Markets
Rural Advancement Foundation International- USA
Sustainable Agriculture Coalition
United Poultry Growers Association

Testimony to the Senate Committee on the Judiciary
"Monopsony Issues in Agriculture: Buying Power of Processors in Our Nation's Agricultural Markets."

Given by:

DeeVon Bailey, Ph. D.
Department of Economics and Cooperative Extension Service
Utah State University
Logan, Utah

October 30, 2003

My name is DeeVon Bailey. I am a professor and extension economist in the Department of Economics at Utah State University. I grew up in the small community of Paradise, Utah working on my father's farm and my grandfather's ranch. I managed our family's cattle ranch for two years following my uncle's death in a farming accident. I love the cattle business, but also know first hand the inherent business risks associated with that business. I believe I also understand the concerns producers have about the changing structure of U.S. agriculture, especially in regard to packer concentration. I would like to begin by providing a few details about the U.S. meat industry and then discuss some recent research I have been involved with relative to this industry.

In general, the packing industry has done a very good job of positioning itself to be cost competitive. Efforts to improve efficiency through reducing costs are a central theme of the packing industry and have resulted in more meat being available at lower real prices to U.S. consumers and our trading partners than ever before. For the most part, consumers trust the meat inspection system and the U.S. has been spared any general consumer hysteria about meat safety such as has been experienced in Europe, Japan, and more recently Canada with their *BSE* (*Bovine Spongiform Encephalopathy*) crises.

The livestock market lacks some of the characteristics associated with classically-defined competitive markets. Processing firms are few and very large. In the case of beef, only three firms account for a large share of the market. While the existence of large firms does not guarantee non-competitive behavior, many livestock producers are concerned about the potential these firms have for exercising market power. Indeed, the most noteworthy feature of the U.S. livestock marketing system during the past 15-30 years has been this movement toward fewer and larger firms mostly at the processing level but also at the farm or feedlot level. For example, the market share of the four largest firms (CR4) for slaughtered steers and heifers grew from 30% in 1978 to 79.6% in 2002. However, the CR4 in 1992 was 77.8% indicating very modest growth in the market share of these firms during the last decade. The hog slaughter CR4 has also grown modestly from 49% in 1996 to about 56.7% in 2002 (USDA, GIPSA). Large feedlots (over 32,000 head capacity) account for almost two-thirds of all fed steers and heifers in the U. S. (USDA, GIPSA).

Concentration has also increased at the food retail and distribution levels. Large retailers have also become major players in food retailing. Large retailers provide low-cost, convenient access to food products. As a result, large retailers may in fact be replacing, at least to some degree, large processing firms as the market "captains" of the food marketing chain.

In 1999, a colleague, Lynn Hunnicutt, and I entered into a cooperative agreement with USDA, GIPSA. This agreement gave us access to a confidential dataset reporting all of the individual transactions for four beef packers in a single, major beef production area of the country over a 15-month period during the mid-1990s. The data included information on packer purchases from over 300 feedlots during the study period. The purpose of our research was to examine the effect of transaction costs on the stability of packer-feedlot relationships.

In a competitive, cash market, both packers and feedlot operators should, theoretically, have choices about when and with whom transactions take place. If relationships within cash markets are found to be rigid, that is that market participants tend to have exclusive relationships with each other time, then several possible economic reasons might explain this behavior. One possible explanation for rigid exclusive business relationships might be that packers exercise control over feedlots by somehow dictating the terms under which transactions take place. Another possible explanation for exclusivity is that all feedlots offer about the same price for cattle of the same quality, but that some feedlots and packers simply are able to conduct business at a lower cost than they would if they dealt with other feedlots and packers. In other words, exclusivity may benefit both packers and feedlot operators because transactions costs are minimized by doing so. A final possibility is that exclusivity expresses itself because one packer simply consistently offers a higher price to a feedlot operator for his/her cattle and, as a result, the feedlot consistently sells to that packer.

Economic theory suggests that if large firms compete vigorously with each other that their market shares will be unstable (Gort). Using a spatial statistic technique, we conducted two tests. Our first test was less restrictive than the second and found that, depending on the definition of the spatial statistic, the majority of feedlots (59% to 86%) sold primarily to just one packer (primary buyer) (Table 1).[1] A few feedlots had two primary buyers but almost none of the feedlots had three primary buyers.

Our second test determined if feedlots tended to sell all of their cattle only to primary buyers. We broke the data into two-week time periods (a typical planning horizon between when cattle are purchased and eventually processed) to determine if feedlot operators tended to "switch" between packers from time to time. We found that when feedlot operators sold cattle, they almost always sold all of their cattle to their primary buyers (Table 2). For example, for all transactions (both cash and contract) during the study period feedlots sold only to their primary buyers 80% of the time. This

[1] The test for a primary buyer was if a feedlot statistically sold more than 25% of its cattle to that buyer (packer).

means that if the feedlot operator offered cattle for sale during ten of the two-week periods, he/she sold cattle only to the primary buyer in eight of those ten periods. Most feedlots sold only to their primary buyer(s) in all cases since the median percentage of periods when transactions were only with the primary customer was 100%. This suggests that feedlots did little switching from their primary buyers during the study period and indicates that exclusive and very stable relationships existed between feedlots and packers during this 15-month period.

We tested the reasons for why exclusive, stable relationships existed between these feedlots and packers using regression analysis. We found that the level of previous dealings between a feedlot and a packer significantly influenced the proportion of cattle the feedlot operator sold to that same packer in the current time period. Also, downward adjustments in the proportion of cattle sold by a feedlot to an individual packer were larger than upward adjustments but were done only infrequently (5% of the possible cases). This suggests that once a business relationship has been established between a feedlot and packer that that relationship is more likely to continue in the future than if no previous relationship existed. It also suggests that feedlots frequently make incremental upward adjustments in the proportion of cattle they sell to a primary buyer but that downward adjustments are made infrequently (Tables 3 and 4).

Our results indicate that previous proportions, used as a proxy for all transaction costs, and the presence of a contracting relationship between a feedlot and packer all influenced the proportion of sales between the feedlot and packer. Other proxies for transaction costs, such as feedlot size and market volume, were not shown to have a statistically significant influence on the proportion of sales from a feedlot to a packer. Unfortunately, we had only information about successful bids for cattle and not all the bids that were placed on cattle. As a result, we could only test for adjustments in proportions sold by using the average price packers paid for a base type of cattle (choice, yield grade 3 steers). Although the "sign" for the test was positive as expected, the test could not yield a reliable conclusion since the parameter estimate was not statistically significant.

The results of our analysis suggest that relationships between packers and feedlots can be understood in part through transaction costs. Consequently, these relationships may be mutually beneficial to both packers and feedlots. Perhaps the most important finding in our research is the necessity of incorporating transaction costs into economic models of this industry.

Table1: Categorization of Exclusive Relationships Between Feedlots and Packers

Number of Exclusive Relationships	All Feedlots (no. in the market) Spot (311)	Contract (150)	Entire Mkt. (335)	Excluding Small Feedlots (no. in the market) Spot (260)	Contract (145)	Entire Mkt. (279)
			Smoothed			
None	51 (16.4)	27 (18)	42 (12.3)	34 (13.1)	24 (16.6)	33 (11.8)
One	183 (58.8)	83 (53.3)	209 (62.4)	149 (57.3)	81 (55.9)	162 (58.1)
Two	66 (21.2)	31 (20.7)	76 (22.7)	66 (25.4)	31 (21.4)	76 (27.2)
Three	11 (3.5)	9 (6)	8 (2.4)	11 (4.2)	9 (6.2)	8 (2.9)
			Unsmoothed			
None	4 (1.3)	2 (1.3)	4 (1.2)	1 (0.4)	2 (1.4)	1 (0.4)
One	266 (85.6)	137 (91.3)	295 (88.1)	218 (83.9)	132 (91)	242 (86.7)
Two	41 (13.2)	11 (7.3)	36 (10.8)	41 (15.8)	11 (7.6)	36 (12.9)
Three	0 (0)	0 (0)	0 (0)	0 (0)	0 (0)	0 (0)
			# Head			
None	0 (0)	0 (0)	0 (0)	0 (0)	0 (0)	0 (0)
One	239 (76.9)	135 (91.0)	263 (78.5)	189 (72.7)	130 (89.7)	208 (74.6)
Two	69 (22.2)	15 (10)	68 (20.3)	68 (26.2)	15 (10.3)	67 (24.0)
Three	3 (1.0)	0 (0)	4 (1.2)	3 (1.2)	0 (0)	4 (1.4)

Each column contains the number of feedlots with none, one, two or three exclusive relationships, with percentages of the total number of feedlots being considered in parentheses.

Table 2: Percentage of Periods Feedlots Sell Only to Primary Customer

	Overall Market	Spot Market	Contract Market
Average	80%	94%	80%
Median	100%	100%	100%
Standard Deviation	30%	23%	31%

Table 3: Summary Statistics for Regressors Other Than Price

Variable	Mean	Std Deviation	Minimum	Maximum
Irreversibility (*NEG*$_{ijt}$)	0.11	0.31	0	1
Lagged Spot Market Sales (*PROP*$_{ijt-1}$)	0.25	0.38	0	1
Size of Feedlot (*FLSIZE*$_{ijt}$)	6.21	6.95	1	69
Size of Market (*TOTLOT*$_{ijt}$)	743.00	86.02	551	918
Maximum Price Difference (MPD$_{jxt}$)[a]	-0.27	0.42	-1.77	0.78
Persistent Price Differences (*PERSIST*$_{ijt}$)	0.02	0.13	0	1
Percent Contract Sales (*CS*$_{ijt}$)	0.06	0.22	0	1

[a] Negative numbers imply larger prices offered by competing packers. MPD calculated using sales to all four packing firms.

Number of observations for all variables = 14,908

Table 4: Regression Results, Dependent Variable = % Spot Market Sales to Packer

Variable	Coefficient
Lagged Spot Market Sales (PROP$_{ijt-1}$)	.3436** (.0081)
Irreversibility (NEG$_{ijt}$)	-.4896** (.0072)
Size of Feedlot (FLSIZE$_{it}$)	.00078 (.00044)
Size of Market (TOTLOT$_t$)	6.09 x E^{-6} (2.03 x E^{-5})
Percent Contract Sales (CS$_{ijt}$)	-.0265** (.01)
Maximum Price Difference (MPD$_{jxt}$)	.0031 (.0047)
ρ	-.019945
Adjusted R^2	0.7084

Hausman test statistic for random effects: 3306.16**
F-test statistic for fixed effects: 44.27**
Standard errors given in parentheses
*significant at 5% **significant at 1%

Testimony of J. Dudley Butler

Submitted
to the
Committee on the Judiciary
United States Senate

for the hearing on

Monopsony Issues in Agriculture: Buying Power of Processors in our Nation's Agricultural Markets

Mr. Chairman, Ranking Member Leahy, Members of the Committee, I appreciate the opportunity to offer my testimony on the issue of monopsony in agricultural markets, particularly with regard to the abuse of arbitration in agricultural contracts of adhesion.

My name is J. Dudley Butler. I am from Yazoo County, Mississippi where my family and I live on our cattle ranch. I am a practicing trial lawyer, arbitrator and mediator, as well as a cattleman. I am a founding member of the Organization for Competitive Markets. I serve as a member of the Alternative Dispute Resolution committee for the Mississippi Bar Association and I am currently the Chairman of the Cow-Calf Caucus of the National Cattlemen's Beef Association.

I bring to your attention that NCBA General Policy AP 1.1 entitled NCBA Agricultural Policy Statement states in part the following:

> **This statement will guide NCBA's action on behalf of the cattle industry in influencing the government relating to agriculture. Under this statement, NCBA's priorities are to:**

3. **Preserve the right of individual choice in the management of land, water and other resources. Livestock contracts should provide for the use of arbitration to settle any controversy only if, after the controversy arises, both parties consent in writing to use arbitration to settle the controversy;**

I believe that arbitration is a valuable alternative dispute resolution procedure if entered into knowingly and voluntarily. Under the right circumstances it can be fair, cost effective and time saving. Under the wrong circumstances it is destructive, unfair and totally inequitable.

I have always been an admirer of the "old west" and I am thankful for having been able to live and ranch in Wyoming for eight years when I was somewhat younger. An appropriate western analogy to this problem would be as follows:

If a cowboy used his lariat to rope a calf and save its life one day and then later used it to lynch someone, does this mean the lariat is bad? Obviously Not, it means it was properly used in one instance and wrongfully used in the other.

The majority of my law practice involves representing farmers which often includes the attack on onerous mandatory arbitration clauses contained in production contracts. Many of these arbitration clauses are in poultry contracts and require poultry growers to waive any right to a jury trial and also contain cost laden provisions that make arbitration inaccessible as well as provisions limiting the remedies normally afforded to a claimant. In other words, the litigation forum is taken away by contract and the arbitration forum is either taken away by economics or greatly restricted, thereby leaving the grower with either no forum in which to bring his dispute or a forum with

remedies that are not appropriate. These clauses are forced upon the growers in a "take it or leave it" manner. Corporate concentration in conjunction with debt laden producers (*farmer or rancher)* creates an atmosphere that eliminates any producer bargaining power whatsoever.

Surely producers should not be required to waive their constitutional right to a trial by jury while under such duress. As you well know, the constitutional right of trial by jury is as important as is freedom of speech, religion and other inalienable rights that were granted by the framers of our Constitution.

In the landmark case of *The Breman v. Zapata Off-Shore Co.,* 407 U.S.1, 12 (1972), the Supreme Court noted that the contract fixing a particular forum for resolution of all disputes

> **" was made in arm's-length negotiations by experienced and sophisticated businessmen, and absent some compelling and countervailing reason it should be honored by the parties and enforced by the courts."**

A Poultry Growing Contract is not an arm's-length negotiated agreement, quite the contrary, it is a contract of adhesion presented to the grower on a "take it or leave it" basis. Poultry growers are not experienced and sophisticated businessmen. It should be brought to this committees attention that the original poultry growing contracts did not include mandatory arbitration clauses.

Now deeply in debt, the once independent farmers are no more than contract employees that are micro managed to almost every minute detail by large corporations. Can you imagine being degraded to the point of where you are told when and how to mow the grass around your property? Can you

imagine being told that you either do this or you don't get chickens? This is the state of farmers involved with production contracts today.

Therefore my concern that I am presenting to this committee is that the use of mandatory arbitration clauses along with the waiver of any right to a jury trial is in fact counterproductive to the promotion of the arbitration process. The arbitration process although meant to be expedient and cost effective has become extremely time consuming and expensive under the wording of many of the mandatory clauses now used in production contracts.

I am lead counsel in the case of Gatlin v. Sanderson Farms. In this case Sanderson Farms called Mr. Gatlin on Christmas Day, 1997 to come to the Sanderson Farms' office the next day. On December 26, 1997, Sanderson Farms terminated the remaining fourteen years of Mr. Gatlin's fifteen year contract. Mr. Gatlin tried to arbitrate his case but was precluded from doing so because he could not afford the arbitration deposit in the amount of $8,250.00 that was required for him to proceed with the arbitration. Mr. Gatlin was thereby forced to seek his forum in a court of law. His filing fee in Jones County Circuit Court was $94.00.

On May 12, 2000, Sanderson Farms filed a petition for interlocutory appeal with the Mississippi Supreme Court concerning the enforceability of its arbitration clause which had been ruled unenforceable by the lower court. On July 7, 2003 the Mississippi Supreme Court ruled in favor of Mr. Gatlin.

Mr. Gatlin had won this decision but by this time he no longer had his farm or his wife. He is working as a security guard and is now just one more productive farmer lost to corporate concentration and its lust for power.

This is just one of many examples where mandatory arbitration clauses such as these are having an extremely detrimental effect to the reduction of

litigation. They are, in fact, creating a time consuming new area to be litigated, which is in direct conflict with the whole purpose of alternative dispute resolution.

Clearly any waiver of a right to trial by jury must be clear and voluntary. This right is given to criminals, why is it not provided to law abiding, hard working farmers?

I want to make it perfectly clear that I am not attacking the arbitration process itself. Quite the contrary, I am here to promote it. Therefore, we must look to find ways to alleviate these problems and I think that there is a simple answer. S 91 would mandate that an individual or family farm be allowed to choose a forum, whether it be litigation or arbitration, after the dispute arises and at the time the claim is made. Decisions concerning proper forums have to be made after the type, complexity and amount of the claim is known.

S 91 (The Fair Contracts for Growers Act) is a *fairness bill* that will insure that America's farmers and ranchers will be protected. This is the only way to insure that a knowledgeable and voluntary decision can be made to protect farmers and ranchers against mandatory waiver of trial by jury and mandatory arbitration clauses.

Thank you for the opportunity to provide testimony on this important issue.

STATEMENT OF PAUL D. CARRINGTON

in Support of

THE FAIR CONTRACTS FOR GROWERS ACT, S. 91

Submitted to the
COMMITTEE ON THE JUDICIARY
UNITED STATES SENATE

for the hearing regarding

Monopsony Issues in Agriculture: Buying Power of Processors in our Nation's Agricultural Markets

S. 91 is an important step in restoring the balance in the relationship between agricultural producers and the monopsonists who contract for their produce or production services. That balance has been disturbed in recent years by the Supreme Court's novel and misguided interpretations of the Federal Arbitration Act of 1925.[1] I previously addressed this committee on this issue in connection with the use of arbitration to strip automobile dealers of their rights under state and federal law. I wish to make six points.

1. Agricultural Production Agreements Are Contracts of Adhesion. Contracts between growers and those who contract for their produce or production services in gross are adhesion contracts, i.e., contracts not freely negotiated by the parties. In this respect, they closely resemble the contracts made between automobile manufacturers and their dealers. Such contracts are often made using printed forms and their terms are seldom negotiable by the party lacking effective bargaining power – in this case the growers. Conventional American contract law expressed in the American Law Institute's Restatement of Contracts[2] and in the Uniform Commercial Code adopted in every state[3] caution against the enforcement of overbearing terms in such "adhesion" contracts. One of the first cases refusing to enforce dictated terms in such a "contract" was decided by the Supreme Court of the United States in 1889 in the days of its strongest commitment to freedom of contract.[4] In 1909, Roscoe Pound, a legendary scholar and for twenty years the politically conservative dean of the Harvard Law School, published a famous article explaining the need to protect individuals and smaller businesses from overbearing provisions in such instruments.[5]

Accordingly, the terms of insurance policies written and sold by insurers are regulated in every state because citizens who cannot be expected to read and understand the intricate terms of the policies they buy. State franchise investment laws have also been enacted in almost every state to protect small business from big business. Federal antitrust laws also bear directly on these relationships, protecting weaker parties from such abuses of economic power.

2. Mandatory Arbitration Is Not Just Another Means of Enforcing Legal Rights. Those who favor mandatory arbitration often assert that it is just another way to enforce the legal rights of contracting parties. That is simply not so. Commercial arbitration as it has developed in the United States is not a legal process and differs in vital ways from the adjudication of rights by courts. Arbitrators need not be lawyers and are not required to know or enforce the law. They need not explain the reasons for an award. They have no duty to inquire into the facts. While they have a subpoena power, they need not use it and parties presenting their cases to an arbitrator have no right to compel the testimony of witnesses or the production of documents unless the arbitrator chooses to require it. The lack of access to adversary discovery of evidence (such as state and federal courts allow) can prevent a

grower from investigating possible violations of the antitrust laws of the United States or other state or federal laws enacted to protect growers. There is no requirement that a record be kept of the evidence considered by an arbitrator. Because there is generally no such record and no explanation of a decision, there can be no review of a decision to assure its fidelity to the law, the facts, or even the contract. Arbitrators often make decisions that seem to them fair without regard for either the sanctity of contract or the laws regulating the relationship between growers and processors.

3. Mandatory Arbitration Can Be Expensive, Prohibiting Growers from Asserting Their Rights Under Either the Contract or Regulatory Laws Enacted to Protect Them. Advocates of mandatory arbitration often assert that it is less costly. Arbitration that both parties agree to voluntarily, with knowledge of what is at stake, does generally save costs. But poultry and livestock processors can make arbitration expensive for growers by designating an inconvenient process or place of arbitration and by requiring growers to pay more costs than they would be required to pay at their county courthouses.

4. Mandatory Arbitration Does Very Little to Relieve Courts of Caseload. There is no official count of the number of lawsuits not brought because growers are forced to arbitrate, but it is likely to be very small. One reason is that growers and the businessmen with whom they deal are very likely to settle their differences rather than engage in a costly fight. Most commercial disputes are never brought to court at all. At least nine out of ten civil cases filed in our courts are settled without judicial action.

If a grower (or group of growers) has a complaint that is significant enough to warrant legal action and a contract with a mandatory arbitration clause, he is likely to go to court first to challenge the enforceability of the arbitration clause.[7] After the court rules on the enforceability of the arbitration clause, then the original complaint will or will not move forward. Thus, even if the court upholds the arbitration clause, the case has become part of the court's caseload. If the clause is found invalid, the case has been double the burden on the court due to the arbitration clause.

5. Mandatory Arbitration Weakens the Bargaining Power of Growers in All Their Relations with Processors. A legal claim that a grower can only resolve through arbitration and cannot take to court is a less valuable claim and the smaller value will be reflected in any settlement the parties might reach. This is so even if the arbitration is conducted with economy and dispatch. The identity of the commercial arbitrator is a reason this is so. To the arbitrator, the processor is potentially a "repeat player" who may bring the arbitrator more business in other disputes with other growers. The grower is a "single-shot player" who is much less likely to be a source of return business for the neutral arbitrator. Of course, good arbitrators do not think about this. But the parties cannot help doing so. This suspected bias has been given some confirmation in an empirical study by Professor Lisa Bingham of the Indiana University Business School.[8] Its effect is to intimidate the "single-shot player" making him or her slower to advance a claim and quicker to settle it on less favorable terms. This is especially the case if the claim arises from a state or federal regulatory law such as the antitrust laws that an arbitrator is less likely to understand or faithfully enforce than is any American law court, whether state or federal.

6. S. 91 is needed to reverse the possible and unintended pre-emption of state law regulating grower contracts. In 1982, in *Southland Corp. v. Keating*[9] the Supreme Court held that the Federal Arbitration Act pre-empts state laws conferring legal rights on franchisees to protect them from franchisors, at least insofar as such laws authorized franchisees to go to court. This general rule of preemption has been applied in other contexts as well.[10]

This was a serious intrusion on the sovereignty of state government. Nothing could have been further from the mind of the Congress enacting the Federal Arbitration Act. The purpose in 1925 was to protect state law from intrusive decisions by federal judges.[11] When the issue of pre-emption was presented to the Court again in 1995, twenty states filed amici

briefs asking the Court to overrule that decision. The Court nevertheless adhered to it, but with apologies explaining that, although *Southland* was wrongly decided, some persons had relied on the previous decision so that it would be better overruled by Congress.[12] S. 91 would be a response to the Court's acknowledgment of its own error.

NOTES

[*] The author of this statement is Chadwick Professor of Law at Duke University and was for a decade the dean of that university's law school. He is an elected Fellow of both the American Academy of Arts and Sciences and of the American Bar Foundation. He was also the founder in 1983 and for many years the chairman of the governing board of the Private Adjudication Center, a non-profit organization that has conducted thousands of arbitrations. He has frequently been involved in the work of the Judicial Conference of the United States and numerous bar organizations and academic groups. His work has on diverse occasions been supported by the Ford, Guggenheim, Meyer, Rockefeller, and Smith-Richardson Foundations. He is the author or editor of seven books and over two hundred articles published in legal journals. He has taught in fifteen American law schools and in numerous other countries. He presently serves on a panel of the National Academy of Science examining the interface of law and science. In recent years, he has written several articles about arbitration law.

[1] Paul D. Carrington & Paul H. Haagen, *Contract and Jurisdiction,* 1996 Sup. Ct. Rev. 331 (1997). See also Jean R. Sternlight, *Panacea or Corporate Tool?: Debunking the Supreme Court's Preference for Binding Arbitration,* 74 Wash U L Q 637 (1996); Jeffrey W. Stempel, *Reflections on Judicial ADR and the Multi-Door Courthouse at Twenty: Fait Accompli, Failed Overture, or Fledgling Adulthood,* 11 Ohio St J on Disp. Resol. 297 (1996); and see Thomas E. Carbonneau, *Arbitration and the U. S. Supreme Court: A Plea for Statutory Reform,* 5 Ohio St. J on Disp Resol 231 (1989).

[2] *Restatement (Second) of Contracts* §211.

[3] §2-302.

[4] *Liverpool Steam Co. v. Phenix Ins. Co.,* 129 U.S. 397, 441.

[5] *Liberty of Contract,* 18 Yale L J 454 (1909). See also Edwin Patterson, *The Delivery of A Life-Insurance Policy,* 33 Harv L Rev 198 (1919); Friedrich Kessler, *Contracts of Adhesion – Some Thoughts About Freedom of Contract,* 43 Col L Rev 629, 632 (1943); W. David Slawson, *Mass Contracts: Lawful Fraud in California,* 48 S Cal L Rev 1 (1974). Lewis A. Kornhauser, *Unconscionability in Standard Forms,* 64 Cal L Rev 1152 (1976).

[6] Louis Kenworthy, Stewart Macaulay & Joel Rogers, *"The More Things Change" – Business Litigation and Governance in the Automobile Industry,* 21 Law & Soc. Inq. 660, 667 (1996).

[7] Sanderson Farms, Inc. v. Gatlin, 848 So. 2d 828 (Miss. 2003).

[8] *On Repeat Players, Adhesion Contracts and the Use of Statistics in Judicial Review of Employment Arbitration Awards,* 29 McGeorge L Rev. 233 (1998); *Employment Arbitration: The Repeat Player Effect,* 1 Empl. Rts. & Empl. Policy 189 (1997).

[9] *Southland Corp. v. Keating,* 465 US 1 (1984).

[10] *See, e.g.* Circuit City Stores v. Adams, 532 US 105, 112. (2001).

[11] The legislative history is reviewed in Ian R. Macneil, American Arbitration Law: Reformation, Nationalization, Internationalization 15-133 (Oxford, 1992). See also the opinion of Justice O'Connor dissenting in *Southland Corp,* note 12, at 21.

[12] *Allied-Bruce Terminix Companies, Inc. v. Dobson,* 115 S Ct 834 (1995). Justice Scalia who had concurred in the earlier decision said that he would reverse it whenever he had five votes. 115 S Ct at 844. Justice Thomas joined in Justice Scalia's opinion. Unfortunately, Justice O'Connor was no longer willing to stand by her *Southland* dissent, being dissuaded wholly by "considerations of stare decisis." Justices Stevens and Rehnquist, who also dissented in *Southland* nevertheless joined the majority in *Allied Bruce Terminix.*

Monopsony in Markets for Agricultural Products:

A Serious Problem in Need of a Remedy

Statement prepared for the hearing on
"Monopsony Issues in Agriculture:
Buying Power of Processors in Our Nation's Agricultural Markets."
held by the
Senate Judiciary Committee,
October 30, 2003.

By

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This statement draws heavily on a paper analyzing more generally the legal regulation of agricultural product markets that I presented at the meeting of the Law and Society Association in Pittsburgh, June 5-8, 2003, and at the annual meeting of the Organization for Competitive Markets in Kansas City on July 25, 2003. I am grateful for the suggestions and comments that I received at both meetings. Rev.

I am honored to have been asked to offer my views on the problems created by monoposonistic markets for agricultural products. In the last five years, I have been particularly interested in issues involving competition in the markets for such products. In 2000, I published an article in the Wisconsin Law Review: *Concentration and the Destruction of Competition in Agricultural Markets: The Case for Change in Public Policy*, 2000 Wis L. Rev. 531. A central thesis of that article was that there are serious problems of market failure in agriculture directly related to the high and increasing levels of concentration in the industries buying from farmers and ranchers. I urged increased antitrust enforcement and also suggested legislative action in addition to antitrust enforcement was essential to restoring competition in agricultural markets. The goal of legislation should be to facilitate the operation of a dynamic market process that is efficient, transparent, open and fair.

Farmers are poorly served by existing market structures and practices. Farmers and ranchers today confront excessive concentration in most of the industries buying and processing agricultural products including those in meat, grain and dairy. The existence of concentrated markets creates the incentive and the capacity for such firms to engage in conduct aimed at exploiting those participants with limited options and to entrench existing market power against the threat of deconcentrating and effective competition.

Free and open markets are generally the best institutional structure for achieving all the important goals of economic policy: efficiency, dynamic growth, equitable allocation of resources, opportunity for all participants. Economists and policy makers have also long recognized that markets are not inherently fair, efficient or open. Where markets are unconcentrated, there are many buyers and sellers, and there is a strong tendency for efficient, workable and fair methods to develop as the inevitable outcome of the interaction of many participants all seeking a neutral and open market place.

But no such inherent tendency exists in markets where there is a substantial difference in size between buyers and sellers and the market is also highly concentrated, i.e., there are few firms altogether on one side. Also, if one side has significant and persistent advantages in information or some other important element related to the transactions between buyer and seller, then too such a market is unlikely to experience much pressure for desirable conditions. There is a grave danger that strategic conduct will shape such markets frustrating the goals of an efficient, open, fair and accessible marketplace. This in turn imposes immediate burdens on the disfavored class of participants and ultimately on consumers and the economy as a whole as less efficient production and market transactions take place.

When markets lack the inherent tendencies to create desirable conditions, the law can play a vital role in defining rules for the participants that reduce their capacity to engage in strategic conduct and restore greater balance between the parties. The statute books contain many such laws including ones regulating credit, insurance, product safety, job safety, franchising of various kinds (e.g., gas stations, fast food, automobile dealerships), energy markets and, of course, securities markets.

Because of problems of fraud and deceit in energy and public stock markets exemplified by Enron and Worldcom, we are witnessing today a renewed awareness that markets require well crafted and effectively enforced rules to ensure that they work in the best interest of the general public, producers, investors, and consumers. Such regulation does not replace the market. It seeks to facilitate its operation by ensuring that all participants have reasonable information, equitable treatment, and access. It has been, I think, the genus of our economic system that we have over time preferred, whenever its is feasible, market facilitating regulation to governmental command and control of economic activity.[1]

The focus of this hearing is on the problems created by the monopsonistic character of the markets into which farmers and ranchers sell their products and the potential role of law, both antitrust and market specific regulation, to restore open and competitive markets. My brief answers are that there is strong evidence of abuse including price manipulation by buyers, discrimination among producers, and conduct strategically aimed at exploiting and entrenching market power. The harder problem is how to restore a fair, open, equitable and accessible market.

Antitrust law can and should make an important contribution especially when other agencies of government having more relevant powers lack the political will and institutional capacity to act. However, the failure of antitrust law enforcers to understand the differences between monopsonistic power issues and the more familiar seller power analysis as well as to shape relevant enforcement policies, has greatly weakened the impact of antitrust law. The lack of transparency concerning decisions to enforce, or, more often, not to enforce antitrust law in monopsonistic contexts further diminishes the role of antitrust because the critics of enforcement policy are kept in unjustified ignorance of the bases for the decisions being made.

But in the contemporary enforcement world and given the inherent limits to antitrust law and its enforcement, market specific laws that limit or eliminate opportunities for specific kinds of strategic behavior are essential to achieving improved market behavior in a timely and effective way. Such rules can constrain strategic and opportunistic behavior as well as facilitate more open, accessible and efficient markets for agricultural products.

This statement, first, describes the structure of the key buying markets for agricultural products. Second, it outlines the kinds of monopsonistic problems that exist in the contemporary agricultural product markets. Third, it evaluates the potential for antitrust law to deal with those problems. Fourth, it describes and evaluates the existing market specific regulation that could

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[1] Professor John McMillan of the Stanford University Business School recently published a relevant book on the market process, Reinventing the Bazaar: A History of Markets (Norton, 2002). This book emphasizes that for markets to fulfill their social function they must be competitive and equitable with good information and access. Government regulation, he contends, can ensure that markets remain open, balanced and fair when they are otherwise vulnerable to strategic conduct and self-seeking manipulation.

eliminate some of the worst abuses and reduce the incentives for strategic use of buyer power. The final section suggests improvements in antitrust enforcement and options for better market specific regulation for agricultural product markets.

I. The Monopsonistic Market Structure in Agricultural Markets

It has become a common place that concentration has increased dramatically in most of the markets into which farmers and ranchers sell their products. In beef, four firms control more than 80% of the national slaughter of steers with, of course, even higher concentration in the regional markets in which livestock are actually sold. The pending acquisition of Farmland by Smithfield will increase national concentration in hog slaughter to nearly 65% in the top four firms. Similar concentration exists in poultry. Moreover, as with beef, the levels of regional concentration in poultry and hogs, the relevant markets for producers, are even more concentrated. In addition, increasingly the same enterprise owns dominant positions in more than one type of livestock slaughter. Tyson is the leader with the largest share of poultry, nearly one-third of all steers slaughtered in its facilities and the second largest share of hog slaughter, approximately 20%. Smithfield dominates hogs and is an increasing presence in beef.

The same process of concentration is taking place in milk. Dean controls over about 30% of the nation's fluid milk. From the standpoint of dairy farmers through out the country, this means that there are going to be few buyers for their fluid milk. Further complicating this relationship, Dairy Farmers of America (DFA), a very large dairy cooperative, represents farmers and has a long term contract with Dean to supply milk to most of its processing plants and has a 50% stock interest in National Dairy, another large processor. Earlier this year, Hood, another major fluid milk processor, proposed merger with National.[2] DFA would have retained a substantial ownership stake in the merged entity as well as a supply relationship with it. Because of objections by a New England based dairy cooperative that its members would loose Hood as their outlet (Dean and DFA are the only other major milk handlers in the region), the parties abandoned the merger and have proposed a new deal in which each with take a substantial stock ownership position in the other and they will share top management. Under this deal, DFA will get control of milk supplies to the Virginia plant of Hood, but will not have supply rights in New England.[3]

Other elements of the dairy business are similarly concentrated and often becoming more concentrated. Milk not used for drinking is manufactured into cheese, butter, ice cream, or dried milk. Based on estimates for the year 2000, only 26% of all milk production is used as fluid milk, 37% is converted to cheese, about 13% becomes butter and another 8% is made into ice

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[2] Boston Globe, 5/13/2003 at D2.

[3] Id.

cream.[4] Kraft dominates the cheese market with nearly a third of that business. Land O' Lakes, the second largest dairy cooperative in the country, is the leading butter producer in the United States controlling about 30% of the butter business. Thus, in each of the major uses of milk there is a dominant firm and each of those firm's has an interest as a buyer to keep prices down. Hence, there is little incentive to compete for supplies by raising price.

Finally in grain, we have seen a number of mergers and combinations resulting in increased concentration on the buying side for wheat, soybeans, and corn. For example, ADM acquired Farmland's soybean operations, both domestic and foreign, increasing its position of dominance in that field. Cargill, already the largest or second largest grain trader in the world, acquired Continental's grain trading facilities after some modest divestiture, thus further increasing concentration in all areas of grain.

Further downstream in food processing and food retailing, we have also seen a number of mergers and combination that effectively increase concentration on the buying side at both levels. For example, when Ralston Purina and Nestle combined, the resulting entity became the largest buyer, taking as much as 50% of all animal meal which is now largely used in pet food.[5]

Grocery mergers and internal expansion by the largest firms have combined to increase concentration on the grocery buying side with the top five firms now sell more than 40% of groceries sold through supermarkets in the United States. As major buyers of food products, these chains have great power over their upstream suppliers even if their market shares, on a national basis, do not seem overwhelming when viewed in terms of seller market power.

II. Monopsonistic Conduct in the Markets for Agricultural Products

Concentration creates incentives to exercise the resulting market power. In surveying these issues, four categories are helpful: (1) the manipulation of public market prices to ensure lower costs to the buyer on the contractual side of the market; (2) direct manipulation and depression of producer prices often manifest in the increasing spread between the farm price and the wholesale or retail price of the product involved; (3) discriminatory contracting practices that avoid the open, public market; (4) imposing inequitable burdens on the producers. I will discuss each of these categories of problem briefly.

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[4] Table 8-25, Agricultural Statistics 2002. Furthermore, milk production has risen from 148 billion pounds in 1991 to 168 billion pounds in 2000.

[5] See, Comment on Nestle-Purina Merger, submitted by the National Grange (this comment was prepared and signed by Professor Einer Elhauge of Harvard Law School). Since the "mad-cow" experience, the use of animal meal for feed to livestock intended for human consumption has been prohibited. Hence, use in pet food is an increasingly important outlet for this byproduct of the livestock industry

1. Manipulation of Market Prices

The basic idea is to manipulate the public price of a commodity where relatively low volumes are traded in order to affect the off-exchange prices where such prices are set in relation to the public market price. The impact on the integrity of the market process is the same whether the manipulation comes from the buyer or seller side. False signals are being sent. In the past, buyers of cheese, eggs and butter manipulated the pre-World War I exchanges to create artificially low prices that then governed many off-exchange supply contracts.[6] The major gas refiners used the same strategy to manipulate the wholesale price of gasoline in the 1930s.[7]

In the cheese business, Kraft and others manipulated their purchases of cheese on the old Green Bay cheese exchange to drive down the price of cheese.[8] This in turn depressed the amount farmers got for their milk. The National Cheese Exchange in Green Bay, Wisconsin held a weekly public sale for a 30 minutes or so every Friday at which very little cheese was actually sold. But this public market provided the basis for a vast volume of cheese sales based on contracts. Hence, Kraft and other major buyers had a strong incentive to be sellers in that market to drive down the price of the products they were buying. According to Mueller and Marion, the effect of this manipulation was to dampen down price increases and drive prices lower in periods of price decline because of increased supply relative to demand.[9] Federal antitrust law does not

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[6] Discussed in Peter Carstensen, The Content of the Hollow Core of Antitrust: The Chicago Board of Trade Case and the Meaning of the "Rule of Reason" in Restraint of Trade Analysis, 15 *Research in Law and Economics* 1 (1992).

[7] US v. Socony, 310 US 150 (1940).

[8] Willard F. Mueller, Bruce Marion, et al, *Cheese Pricing: A Study of the National Cheese Exchange* (Report to the Wisconsin Department of Agriculture, Trade and Consumer Protection), March 1996. After its completion, while new administrative rules were being considered, the Exchange closed down and the cheese contract was moved to the Chicago Mercantile Exchange where it is subject to regulatory oversight by the Commodities Futures Trading Commission.

[9] The cheese contract now traded on the Chicago Mercantile Exchange has the same low volume and great economic significance for both cheese producers and dairy farmers. There are rumors that the price continues to behave in unusual ways that suggest that interested stakeholders may continue to manipulate it. A counter story is the allegation that DFA and Land O' Lakes, the two largest dairy cooperatives, manipulated the price of butter to drive up the price of milk. Ice Cream Liquidation v. Land O' Lakes, __F. Supp. 2d__, 2003 WL 1679793 (D. Conn. 2003). The claim is that the butter contract, traded for only a few minutes each week on the Chicago Mercantile Exchange, was manipulated by buying a small quantity of butter on the exchange to increase the price of all milk. Although the putative gain goes to the farmer or at least the farmer's cooperative, to be successful over time, the cooperatives must then limit the production of their members and foreclose new members from joining. Otherwise, the increased

provide a remedy for farmers because they are only "indirect" victims of this conduct. However, they have sought relief under state antitrust laws with varying degrees of success.[10]

In beef and hogs, similar problems of public price manipulation exist. For hogs, the majority of which are now sold under various production contracts, the price set in the upper Midwest still provides the basis for pricing many production contracts. By staying out of the public market at crucial times of the day or bidding low, the handful of packers that buy hogs can strongly influence the contract prices that they will pay for the bulk of their production.[11] The incentive to engage in strategic conduct with respect to the public market prices is palpable. Moreover, Smithfield's acquisition of Farmland will reduce the number of potentially competing buyers in the price setting market from 6 to 5. Reduction in the number of bidders when the initial number is small can have very significant impact on the viability of the bidding process. Moreover, interdependent action with respect to bidding becomes increasingly attractive as the number of bidders decreases, and each bidder has an incentive to depress the auction price as a means of controlling its contract prices. Nevertheless, the Department of Justice has allowed the Farmland acquisition without any explanation of why it has concluded that this deal is not likely to have significant anticompetitive effects.

In beef, there is less dominance of production contracts, but they are increasingly important.[12] Such contractual commitments are called "captive supplies." Here again, the tradeoff between public market prices and the price to be paid for contract cattle invites manipulation. By lowering the market price, the packer can save substantially on its contract supplies.

2. Use of Buying Power Directly to Depress and Manipulate Prices

Basically, a volume buyer dealing with a number of small suppliers has substantial leverage to set a price within some range and stick with it. The sellers have to deal with the buyer eventually. Beef and hog feeding operations have faced highly concentrated packer buying

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price will induce increased overall supply until the market price collapses and revenues decline for all. In fact this is what has happened with milk prices. Thus, price manipulation is less likely to be productive for producers than for buyers.

[10] See references at note 21, infra.

[11] See Statement of Michael Stumo on Behalf of OCM at the July 23, 2003 hearing of the Senate Judiciary Committee's Subcommittee on Antitrust, Competition and Consumer Rights (hearing on the acquisition of Farmland).

[12] Senator Enzi in introducing S 1044 stressed the rapid growth of contract (captive) cattle deals in the major cattle growing regions of the great plains and Midwest. Congressional Record, May 13, 2003, at S6070.

power for a longer time. That experience shows that the slaughter houses pursue two compatible goals. First, they can use the power to drive down the cost of inputs as discussed earlier. If the farmer has any substantial sunk investment in the business, he or she will continue to produce for a considerable period of time even though the return is substantially below an acceptable level. Moreover, even in periods of short supply when prices rise, the use of buying power can limit the impact of that increase and deny to the producer the full benefit of the increased demand relative to supply. Second, to avoid the risk of disruption from other producers making inroads into their sources of supply and to deter new entrants, powerful buyers have an interest in creating barriers by tying up supplies through contractual arrangements. This makes it much more difficult to obtain the supplies necessary to enter or expand a processing business. Further upstream, monopsonistic buyer power in animal meal resulting from the acquisition of Purina will also affect the total price feeders get for livestock and poultry.

In milk markets, the history of cheese price manipulation is the best known example of how monopsonistic buying practices, distant from the farm (i.e., at the level of cheese buying) can directly influence the price of milk at the farm gate. Additional evidence of increasing spreads between farm gate and retail prices for milk has come from the work of Professor Cotteril looking at the highly concentrated New England milk markets. The spread between farm and consumer increased as the milk processing market became more concentrated.[13]

3) Discriminatory Pricing Practices

The power of dominant buyers has another deleterious impact on the market–they have the power to engage in discriminatory buying practices. As a result, there are significant differences in the prices paid for like grade and quality livestock favoring the farmers, feedlot operators and ranchers who have received long run beef supply contracts (captive supply) in comparison to those operators who sell in the spot market.[14]

There is no legitimate business justification for such differential prices. The primary effect is to disfavor the public market. Given the option, feeders will prefer contract sales. But contract livestock are withdrawn from the spot market, and this results in an increasingly thin public market. Yet this same spot market directly and indirectly influences livestock futures prices, the prices for calves and feeder stock, as well as the price for captive sales. As the public market signals become more unreliable, this makes it more and more difficult for farmers and ranchers to operate their businesses effectively. Thus, the impact of this price differential is to manipulate the entire price structure for beef and hogs.

As concentration increases on the buying side in milk, the same problems are likely to

[13] Cotterill, R.W., and A. W. Franklin. "The Public Interest and Private Economic Power: A Case Study of the Northeast Dairy Compact," May 3, 2001.

[14] These results are consistent across a large number of studies done for GIPSA.

emerge. The pooling of basic compensation for all grade A milk in any milk marketing order area does reduce the capacity of buyers to discriminate, but a central element of compensation is the extra payments for quality factors. As to these there is no way presently to ensure that all dairy farms willing and able to produce such factors get equal treatment when the number of buyers is limited. In the past the presence of multiple buyers provided a competitive market check on any unjustified refusal by a buyer to recognize valuable qualities.

We are seeing increasing use of contracting in grain production as well. Here too, the risk of discriminatory treatment of farmers is serious. No rules or regulations guarantee equal access to producers willing to provide the type of productive effort desired by buyers. My impression is that currently, the transactional market still dominates the area so that buyers are not yet as vulnerable to price manipulation through contracts, but as the use of contracting grows without regulation the potential will increase that the buyers will use contracts to manipulate the public market price and so depress prices to farmers while at the same time inducing them to enter into contractual relationships that reduce the public market and create even more misleading price signals.

4) The Imposition of Unjustified, Non-Price Burdens on Producers

The use of contracting and other practices by buyers of agricultural products operating in monopsonistic markets allows those buyers to impose additional burdens on producers. In the case of beef only chosen operators are given access to captive supply contracts. This imposes negative price differentials on many of the small and middle sized cattle producers in the country. Hence, even if the average prices for cattle combining captive and spot market sales were reasonable, this systematic differentiation among sellers creates serious equity problems and threatens the viability of our traditional farming system.

The same problems only worse exist in hogs. In some regions, if the single major buyer determines for any reason to refuse to deal, a farmer's entire investment is made worthless. Such farmers become serf-like in their dependence on the buyer and will accept any contract terms that are imposed. This includes grossly unfair, compulsory arbitration clauses that effectively eliminate the modest protections afforded by such laws as the Packers and Stockyards Act (PSA) intended to protected farmers from exactly this kind of exploitation.[15]

In poultry there is no longer a spot or public market for general production. All supplies are captive under contracts that impose a wide variety of unfair conditions on the growers. The contract terms imposed on them reflect the power of the producer which can manipulate income by a variety of devices.[16] Moreover, as in the hog contracts, the poultry buyers impose a variety

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[15] The PSA is found at 7 USC 181 et seq.

[16] See, Roth, Redressing Unfairness in the New Agricultural Labor Arrangements: An Overview of Litigation Seeking Remedies for Contract Poultry Growers, 25 U. Memphis L.

of other constraints on their farmer suppliers that deny access to legal rights by compulsory arbitration terms including unconscionable notice requirements.[17] In fact, the Attorney General of Oklahoma has offered the opinion that many contracts for production of crops and livestock are now contracts of adhesion which may in fact reduce independent farmers to the position of employees.[18]

The implication of these kinds of contract terms for efficient market operation is threefold. First, the favored operator has an incentive to serve its economic master because its next best option involves a substantial loss of revenue. Such an operator is not well positioned to bargain effectively on the terms of the transaction. Second, buyers are under no obligation to deal with all comers on equal terms, and so they can refuse to deal with any producer for any reason or no reason. The fact of high concentration on the buyers' side means that such refusals will often deny access to the market altogether as in poultry and hogs in some regions or to the more lucrative contract market as is the case in beef. Indeed, in those markets where open market sales are still possible, such buyers can refuse even to bid and so can eliminate a disfavored operator from the business entirely. Third, supply contracts are "secret" because the buyers claim the terms are confidential business information. Hence, farmers and ranchers usually lack the information necessary to evaluate the reasonableness of the terms that they are being offered. The capacity for this concentrated buying power to disrupt the market and contribute to inefficiency and market failure is a product not only of the concentration of these markets, but also the legal and institutional structure of the markets within which farm products are sold.

Down stream buyer power influences agricultural product markets as well. Brand name or differentiated retail grocery producers must get their products into a substantial number of stores to achieve the necessary volume for efficient operation. Hence, the producer needs to have many or even most large retail chains as customers. This confers on each chain substantial power to demand payments for access to its retail space, e.g., slotting allowances. Such buying power can foreclose access to the market to small firms that can not afford to make such payments. Moreover, the processors who make such payments are powerful enough buyers who will pass back to the farmer and rancher these costs. This will ultimately result in further reductions of farm income because the farmers and ranchers of America are so atomistic in structure that they can not resist effectively the reduction in prices inflicted on them. When processors urge that merger will give them greater "bargaining power," they are announcing that they plan to use their

Rev.1207 (1995). See also, Hamilton, Broiler Contracting in the United States: A Current Contract Analysis Addressing Legal Issues and Grower Concerns, 7 Drake J. Ag. L. 43 (2002).

[17] See, Miller, Contracting in Agriculture: Potential Problems, 8 Drake J. Ag. L. 57 (2003) (the author is a lawyer working for the Farm Bureau which makes his thoughtful critique of current contracting practices even more compelling).

[18] Oklahoma Attorney General Opinions 01-17 (April 11, 2001)

buying power to reduce the prices paid to farmers while trying to keep their prices to retailers up.

III. The Role of Antitrust Law in the Operation of Agricultural Markets

Antitrust law focuses on two elements of markets–their structure and conduct. Merger and monopoly law address structural issues. Conspiracy law and the aspect of monopoly law concerned with exclusionary and exploitative conduct provide the rules for the conduct element of antitrust.

The Clayton Act's prohibition of mergers that "may substantially lessen competition or tend to create a monopoly" is the most actively enforced element of structural law. The objective in merger law is to prevent markets from becoming unduly concentrated. Monopoly law is the ultimate recourse: when market structure has reached monopoly, then dissolution of the monopoly becomes a remedy. The key in both merger and monopoly law is to understand the nature of the markets involved and so be able to determine when a level of concentration raises serious risks of anticompetitive results.

Conduct elements of antitrust focus on the identification and prohibition of conduct that has adverse economic effect and lacks a redeeming business justification. Because antitrust focuses on individual actions and actors it does not have the capacity to establish market specific regulations for the general conduct of actors. It can and does forbid naked restraints such as those created by price fixing cartels or group boycotts having as their goal the elimination of a competitor or class of competitors from the market. Under the rule of reason, antitrust law allows courts to make more focused judgments about the merits of particular actions, but recognizing the generalized character of such results, the tendency is to allow a wide range of conduct. This is particularly true when the effect of the challenged conduct is only to impose harm on an individual enterprise.

The central question for agriculture is how to apply these antitrust concerns when farmers and ranchers sell goods into concentrated markets. The analysis is of buyer power. While not unique to agriculture, these issues are much more relevant here than in many other areas of the economy and much less well developed. There is long standing recognition in case law and economics that anticompetitive consequences can arise from increased buyer power as much as from increased seller power.[19] In the last few years, this insight has received powerful support from several courts of appeal decisions and by the Antitrust Division's challenge to the Cargill acquisition of Continental Grain.

The three leading court of appeals decisions involved a variety of businesses. In 2000, the Seventh Circuit Court of Appeals upheld the Federal Trade Commission's challenge to the efforts of Toys R Us (TRU), a major toy retailer, to block its suppliers selling toys to TRU's

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[19] Mandeville Island Farms v. American Crystal Sugar, 196 US 219 (1948); see Blair & Harrison, Monopsony: Antitrust Law and Economics (1993).

discount competitors.[20] TRU is the largest retailer of toys in the country-selling about 20%. It induced its major suppliers to refuse to provide comparable toys to its lowest price competitors in order to protect its profit margins

In the same year and more directly related to agriculture, the Ninth Circuit has upheld the right of dairy farmers in California to sue the major cheese makers for the reduced milk prices that resulted from their manipulation of cheese prices.[21] This decision most clearly recognized and articulated the stake of farmers and ranchers in having workably competitive markets into which they could sell their products.

In 2001, the Second Circuit upheld a class action by employees of oil and gas companies that challenged information exchanges among these employers that allegedly had the effect of stabilizing wage competition and depressing wages for the members of the class.[22] Again, the decision canvassed the legal and economic bases for authorizing such cases and concluded that there was a strong public interest in preserving and promoting competition on the buying side of markets. The court also emphasized that in buyer power cases the incentives of the parties to collude are different from those in a seller side conspiracy. Specifically, the parties have a much greater incentive not to cheat by raising the prices they pay. In a selling conspiracy, there is an incentive to cheat because a slight price reduction can capture a large sales volume.

The challenge to Cargill's acquisition of Continental, two of the largest grain merchants in the United States, resulted in a consent decree so it has less precedential value, but stands as an indication of the willingness of the antitrust law enforcers to focus exclusively on adverse buyer power concerns resulting from a proposed merger.[23] The position of the Department of Justice

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[20] Toys R Us v. FTC, 221 F3rd 1334 (7th Cir., 2000)

[21] Knevelbaard Dairies v. Kraft Foods, 232 F3d 979 (9th cir. 2000)(upholding a cause of action under California antitrust law for diary farmers who lost money as a result of the manipulation); but see Servais v. Kraft, 631 NW2d 629 (Wisc. App. 2001) aff'd by an equally divided court, 643 NW2d 92 (Wisc. 2002) cert. denied __US___, 123 S.Ct. 601 (2002) (denying, based on the filed rate doctrine as applied to milk orders, the right under Wisconsin's antitrust law for farmers to collect damages for the same conduct). The Wisconsin position on filed rate is extreme and the federal courts are unlikely to accept it. See, Ice Cream Liquidation v. Land O' Lakes, __F. Supp. 2d__, 2003 WL 1679793 (D. Conn. 2003)(rejecting application of the filed rate doctrine to milk order prices).

[22] Todd v. Exxon, 275 F3d 191(2nd Cir. 2001).

[23] US v. Cargill, 2000 WL 1475752 (D.C.C. 2000) (approving the consent decree); the FTC has also recognized although under very limited conditions the relevance of monoposonistic market power. See, In re Walmart, FTC Dkt. No. C-4066 (2003) (approving decree requiring some divestiture in a grocery merger in Puerto Rico with responses to critical comments

was that the merger would have no adverse effects in the downstream markets for grain, but it would have foreclosed competition in buying grain at various specific locations in the country as well as at some key export points. Ultimately, the government consented to the acquisition after the parties divested facilities that in the government's view, but not necessary that of a number of critics, eliminated the risk.

These decisions have re-emphasized the dangers of buying power to the overall competitive operation of the market. In addition, the three court of appeals decisions highlight the ways in which buyer power exploitation can rise from lower market shares as well as involving a different incentive structure with respect to adherence to or defection from the anticompetitive understanding. These analyses have great significance for the analysis of mergers because they demonstrate that actual harms, both unilateral and collusive, can occur as a result of buyer power emerging from much lower market shares than are currently deemed problematic on the selling side of markets. Despite this evidence of the significance for competition of buying power, its implications have not been a primary focus of antitrust analysis.

In developing appropriate buyer power standards, three contexts are important. First, a processor may need access to a large number of downstream buyers in order to be efficient. Slotting allowances in the grocery business and the power of *Toys R Us* illustrate cases where upstream producers need access to either a key retail outlet or to many retail outlets such that failure to get access to that segment of the marketplace results in significant loss of sales. In either situation a buyer with a significant share–10% or more of the national retail market–gets substantial power over the supplier. Each such buyer is an essential element of the producer's marketing process regardless of other outlets. This suggests that merger analysis ought to be attentive to the creation or expansion of such power even where neither the upstream nor the downstream selling market is concentrated in terms of conventional seller market analysis. Similarly, restrictive terms or special obligations on sellers in such contexts might be subject to stricter scrutiny even where the market shares seem low. Moreover, the *Exxon* case teaches that collusive risks arise even in contexts where there are more competitors than would trigger conventional concerns about collusion on the selling side.

The second context that must be understood is that if the seller has relatively few choices even though further downstream the ultimate consumer may have a number of choices, the buyer has power in the upstream market even if it may not have it in the down stream market. As discussed in Part I, an increasing number of agricultural product markets fit this model. The local grain elevator or slaughter house will have substantial power over its suppliers because they have few if any options. When reselling those products, there may not be much power because many other sellers will exist as well. The concerns are analogous to issues that arise when a firm can engage in price discrimination among its customers. Mergers or restraints that increase the capacity for a firm to engage in such conduct are anticompetitive. Similarly, mergers that

acknowledging the legal relevance of buyer power but rejecting application of the theory to the facts of this merger).

increase the capacity of a firm to exploit selectively buying power or agreements which increase the ability of the firm to engage in selective buying practices raise important anticompetitive concerns.

Third, when a buyer imposes lower prices on its supplier, if that supplier can reduce its input costs, it is likely to seek to do so. Thus, when grocery stories reduce what they pay for goods via slotting allowances or requiring other discounts, the processors have every incentive to pass those lower prices on up the supply line. Thus, the ripple effect of a remote downstream price cut will flow up to the parties without the power to respond. The cheese exchange price manipulation is an example. The cheese buyers manipulated their purchases in order to reduce price of cheese, the cheese makers in turn reduced the price of milk to the farmer. The cheese makers may have absorbed some of the lower price but the farmers faced the bulk of that change. Here the implication for both merger and restraint analysis is that adverse effects may well occur in second or third tier supply markets. This means that investigation and evaluation of transactions must be more comprehensive and emphasize the goal of antitrust to protect the competitive process. The fact that the first tear of suppliers may not be harmed does not mean that the overall market process is not put at risk by such mergers or conduct.

Antitrust law lacks a clear empirical or theoretical map of the contexts in which the dangers of buyer power are enhanced or conversely where countervailing market characteristics would make such harms unlikely. While the merger guidelines, for example, provide detailed analysis on the selling side of the circumstances under which an inference of likely adverse effect is or is not plausible, no comparable guidance exists on the buying side. The lack of guidance means that the issues are framed in a very ad hoc way that is very merger specific.[24] Similarly, in cases involving complaints about buyer conduct, the lack of a clearly defined analytic framework recognizing potential harms makes litigation of such cases much more complex and problematic despite the recent court of appeals decisions.

The policy of the Justice Department of not explaining the basis for actions and its refusal to act further undermine the process of developing coherent public policy.[25] The recent decision

[24] For example, the Cargil-Continental merger was allowed after focused divestiture of specific elevators in specific locations. The claim was that this would remedy the localized buying power. But if local markets are linked in any significant way, who gets the elevators and how they will use any potential for differential pricing, would seem both important and complex. Without a clear and coherent theory, supported with empirical data, that identifies the scope and nature of divestiture necessary to ensure both competition overall and non-discrimination it is very hard to evaluate the merits of the settlement.

[25] Professor Warren Grimes has an article forthcoming in the Buffalo Law Review (vol. 51, no. 4) that addresses in a comprehensive way the problems created by the failure of the antitrust enforcement agencies to be transparent in their decision making.

not to challenge the acquisition of Farmland by Smithfield is a prime example.[26] For the reasons given earlier, this combination created a clear, prima facie, risk to the competitive process in hog buying. We do not know whether the government even considered that risk, and if it did, what standards, criteria and facts it deemed relevant to its decision. This greatly limits the capacity for critics of the decision to engage in a meaningful discussion of the merits of specific policy options.

Effective antitrust requires greater appreciation of and deeper analysis of buyer power. This would better inform all antitrust enforcement, but it would be particularly important for cases involving the sale of agricultural products. This, then, is an argument for expanding the scope of carefully developed, general antitrust doctrine to take better and more consistent account of the issues involved in examining the buying side of cases.

Another obstacle exists to private antitrust enforcement. As discussed earlier, the primary anticompetitive effects of monopsony power are often felt at upstream levels two or three stages removed from the point at which the buyer power is applied. Unfortunately, federal antitrust law allows only the first level of victims to recover. This is the teaching of *Illinois Brick*.[27] A number of states have authorized state antitrust actions on behalf of indirect purchasers, but so far federal law has not. Since the direct supplier of a monopsonist is unlikely to want to challenge its powerful buyer, the limit on indirect purchaser claims has a very strong limiting effect on private enforcement of the antitrust laws in buyer power situations.

While such attention to buyer power would have a positive impact on the analysis of future mergers and could provide a basis to challenge some collective conduct among existing buyers in agricultural markets, the fact remains that these markets have already become concentrated or highly concentrated and many aspects of buying power, as illustrated in both the cheese and Toys R Us situations, may not require collusion to bring about harm to the overall working of the market. Antitrust is particularly limited in its doctrinal capacity to respond to unilateral abuse of market power by firms with less than a "monopoly" position. Thus, it is unlikely that antitrust law can either police very completely the conduct of buyers in these concentrated markets or bring about the kind of restructuring of those markets that would significantly reduce the incentives to exploit buyer power.

IV. Agricultural Market Specific Regulation and Its (Non-)Enforcement

There is a long history of government regulation of markets for agricultural products. The stated goals of this regulation include facilitating efficient, fair, informed and equitable

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[26] The Department did not even issue a press release explaining its action. Of course, its press releases are not much help either as can be seen by looking at the statement made in connection with the settlement of the Dean Suiza merger.

[27] Illinois Brick v. Illinois, 431 US 720 (1977).

markets to which all producers have reasonable access. Significant gaps in the coverage of these statutes, lack of essential implementing regulations, and a serious failure in enforcement have combined to create a context in which the problems discussed in Part II of this paper have festered and grown.

A. Legal Framework of Agricultural Market Specific Regulation

Starting at the beginning of the last century, Congress has adopted a series of statutes intended to provide a legal framework for agricultural product markets. An important element was provision of government grading and inspection to ensure both the safety of the products and guarantee that the producers got appropriate grades and weights for their produce.[28] But grading standards did not and do not resolve other problems inherent in the markets for agricultural products–in particular the risks of opportunistic behavior by buyers. In 1920 Congress adopted the PSA that provided for direct regulatory oversight of business practices including payment obligations of buyers of livestock and prohibited unfair and discriminatory practices by slaughter houses, buyers and stockyards.[29] It was the precursor of a number of statutes at both the national and state levels that seek to redress the balance between small business operators and their large customers or suppliers. Thus, the PSA is a blend of provisions controlling conduct based on considerations of fairness and equity and ones focused on avoiding broader anticompetitive effects. The PSA has a clear point of view–it instructs the Secretary to regulate the conduct of packers and stockyards to protect producers and consumers from unfair and discriminatory conduct. It confers on the Secretary of Agriculture expansive rule making authority to implement this mandate. Moreover, the PSA recognizes that harmful results can be either intended or the consequences of the decisions made by packers.

Overtime, the PSA was expanded to respond to the changed context of livestock

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[28] The original food and drug law was adopted in 1906 (Federal Food and Drugs Law, 34 Stat. 768) and is now codified as amended at 21USC sec. 1 et seq.. Grain inspection, grading and weighing was federalized in 1916 to reduce the power of the commodity exchanges in overseeing this essential aspect of the business Grain Inspection Act, codified 7 USC 71 et seq. This made it more feasible for sellers to transact with buyers–processors or exporters–without having to go through one of the commodity markets. Buyers were now able to make bids for grades and quantities of grain where the integrity of the transaction would be overseen. In the 1920s, Congress imposed the first federal oversight of the commodities exchanges themselves including requiring that cooperatives be allowed to join. Commodity Exchange Act, codified at 7 USC 1 et seq. The implication of this requirement was that major gain producers by joining a cooperative were able to share pro rata in the overcharges imposed on exchange based transactions through fixed commission rates. 7 USC 10a; see generally, Peter Carstensen, The Content of the Hollow Core of Antitrust: The Chicago Board of Trade Case and the Meaning of the "Rule of Reason" in Restraint of Trade Analysis, 15 *Research in Law and Economics* 1 (1992).

[29] Packers and Stockyards Act, 1920, codified as 7 USCA 181 et seq.

production. First, the coverage of poultry processors was expanded to include within the PSA's coverage the current organization of the business.[30] Second, livestock producers were given the right to sue for both damages and injunctive relief directly for violations of the PSA.[31] Prior to that change the PSA was strictly a basis for federal regulation of the conduct of meat packers. The most recent farm bill revised the statute to ensure that current hog production contracts were included with its coverage.[32]

Two points about the PSA deserve special emphasis. First, despite the broad authority given the Secretary to adopt regulations implementing the general terms of this statute, the USDA has never used this power. It has sought to develop some law on a case by case basis. The results in recent litigation have been negative.[33] Second, the PSA only covers transactions involving livestock. Hence, despite its clearly articulated goals, the PSA has not provided a basis for controlling discriminatory, exclusionary, or other undesirable conduct in agricultural product markets generally.

The Agricultural Fair Practices Act (AFPA) prohibits specific kinds of unfair trade practices involving coercion of producers into joining or not joining associations.[34] This is a recognition that buyers may be hostile to producer associations and can retaliate by discriminatory refusals to deal with those joining such organizations. The case law enforcing this statute is sparse. In part this is a consequence of the fact that buyers can find many apparently legitimate bases to refuse to deal with any specific producer. The burden on the producer to disprove these claims is substantial. Because the statute does not provide for a reasonable attorney's fee if the producer prevails, the daunting nature of the litigation can further discourage

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[30] See,187 Pub. L. 100-173, amending 7 USC 181 et seq. (1987). Currently, a group of cattle feeders is pursuing a major class action against IBP for its practices with respect to the use of "captive" (i.e., packer owned or controlled) cattle to manipulate the price for open market cattle purchases. In very general terms, the claim is that IBP used its control over captive supplies of beef cattle to manipulate public market prices to the detriment of both sellers in the open market and contract producers. Pickett v. IBP, 197 F.R.D. 510 (M..D. Ala 2000)(procedural issues); see also, R. Smith, Cargill, ConAgra Charged with Market Manipulation, Feed Stuffs, May 20, 2002.

[31] See, 7 USC sec. 209 amended by 1976 Pub. L. 94-410 and 1987 Pub. L. 100-173.

[32] See, Pub. L. 107-171, title X sec. 1052(a) amending 7 USC 182 et seq.

[33] See, IBP v. Glickman,187 F.3d 974 (8th Cir. 1999)(rejecting a USDA challenge under the PSA to a contract that gave IBP a right of first refusal on cattle in certain feed lots, i.e., IBP having made a bid, could ensure it got the cattle, provided it met but did not have to beat, any subsequent bid).

[34] 7 USC sec. 2301 et seq.

its use. In addition, most production contracts contain arbitration clauses that preclude recourse to courts and often entail very restrictive conditions that give substantial advantage to the buyer if arbitration is sought.

The policy of the AFPA remains clear and consistent with the overall structure of the law in this area: it seeks to ensure producers are free from arbitrary and unjustified refusals to deal. Implicitly it acknowledges that in many parts of agriculture, the producer has very few alternatives. Hence, a refusal to deal by one of the few or only potential buyers takes on a much greater economic significance than would be the case if there were more buyers in the market.

These laws have clear common themes: Congress identified specific failures of the agricultural product markets to operate in fair, accessible and efficient ways and adopted specific statutory rules in the belief that these interventions would remedy the problems and restore competition on the merits. However, from a more inclusive perspective, the result is a series of ad hoc responses to particular issues and problems that has not been revised and made systematic to define a workable legal context for agricultural markets.[35]

B. Evaluation of the Legal Framework

The present legal framework regulating agricultural product markets has three major deficiencies: the statutory authority is a patchwork, the USDA has failed to use its powers within the areas over which it has authority to develop appropriate, market facilitating regulations, and its enforcement of even the existing rules has been ineffectual. These failings parallel and reinforce the structural and conduct problems that confront these markets. The result is that the skeletal structure of law and public policy lacks the muscle and coordination necessary to have a substantial influence on the conditions under which most product markets operate.

1. A Patchwork Statutory Framework

First, the authority of the Secretary to police the fairness and equity of treatment in agricultural markets is limited and different from product market to product market. For example, the most pervasive statute, the PSA, applies only to livestock and poultry. No comparable authority exists to police grain or dairy contracts. As market structure and conduct akin to that in livestock and poultry markets come to dominate other sectors, it will be increasingly apparent that there is a need to provide comparable rules and regulations to ensure fairness in pricing and equal access to market opportunities for all farmers and ranchers.

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[35] Various states have also sought to regulate agricultural markets. Such regulation is very vulnerable to strategic conduct by buyers. Buyers can refuse to buy in a state with stricter rules and transfer their business, often at great cost to the farmer suppliers, to another state. Such practices have defeated state efforts to regulate poultry contracts and a recent effort by Missouri to regulate livestock practices.

AFPA only provides a limited protection against refusals to deal based on membership or non-membership in marketing groups. This statute recognizes the potential for unjustified exclusion from the market. But its coverage is limited to a single issue and does not more broadly address the problem of unfair treatment or create criteria that provide workable tools to evaluate and remedy such exclusions. Moreover, the increasingly pervasive use of arbitration can further blunt the impact of such rights. The fundamental policy behind the AFPA is an essential element to facilitating workable market conditions, but its details and lack of rule making authority to define and clarify its application mean that its effectiveness is limited.

2. The Failure to Use Existing Rule-Making Authority

Congress can not continually write and revise regulations that are fine tuned to the needs of specific markets. This is why it often delegates to an agency or department the obligation to draft and revise regulations that implement the basic statutory scheme. The various agricultural market statutes have a range of such authorization from the very sweeping authorization of the PSA to no explicit authorization in AFPA. Nonetheless, it is clear that the USDA has substantial authority to draft rules in a number of important areas and could use its inherent authority to promulgate interpretive rules as well as the more general right of agencies to adopt guidelines that codify agency interpretation which in turn can influence judicial interpretation.

The USDA has failed to use any of the authority given to it to frame rules to facility open, fair and accessible markets in light of prevailing marketing practices. This is a very serious weakness. The most obvious example is the failure over 80 years to use the rule making power of the PSA.

Left to their own devices, large buyers will, as the Attorney General of Oklahoma has opined, force contracts of adhesion onto farmers and ranchers. If the USDA does not define the scope of what is permitted in contractual arrangements, the incentives in the market process with dominant buyers and many, powerless sellers, will drive contracts toward the lowest level of protection for the sellers' interests and accord the buyer the greatest discretion over all aspects of the deal. For example, arbitration clauses in such contracts often deny the producer access to the courts and at the same time impose unfair and inequitable arbitration terms that effectively deny the producer all recourse. Confidentiality clauses keep farmers and ranchers from sharing information that would make them more sophisticated decision makers. Even price reporting is unavailable where buyers are very highly concentrated. What is frustrating from the perspective of preserving and improving an open, fair, efficient and informed transactional market, is the failure of the USDA to use the powers it does have to develop such policies and regulations where it has authority. Such efforts would simultaneously highlight the gaps in its jurisdiction.

It is important to appreciate here that market facilitating regulation includes creating safe harbors and other rules that make clear that buyers do have legitimate discretion with respect to some aspects of their actions. Regulation could define "fair" arbitration clauses and as well as

condemn unfair ones.[36] It can specify the subjects that may be arbitrated and those that may not.

Political will is necessary for rule making. The great economic power of the large buyers translates into substantial political power as well. In addition, there are important groups of producers in the livestock area that gain or believe that they gain from the present system. Hence, the trade associations and farm organizations have not spoken with a single voice on these issues. Interestingly, it appears that many farmers and farm leaders recognize the need for specific reforms but have not found a way to generalize that interest into effective political action. The dispersed farm community thus suffers many of the same problems in carrying forward a legislative or administrative agenda that it faces in the marketplace.

3. Enforcement of the Existing Laws

Third, regulations, however good, have little effect if there is no enforcement. While farmers and ranchers can bring individual cases or class actions, such efforts are very time consuming and may focus more on specific private concerns and less on the broad public interest in ensuring open and fair markets. Moreover, unless those suits directly develop or enforce relatively clear rules, their impact on future conduct can be quite limited.

Thus, effective public law enforcement is essential to the creation and maintenance of fair and open markets. This is the lesson of antitrust law and securities law to name but two examples. In both fields, the government agencies have set policy both directly and through amicus participation in key litigation. In contrast, there is widespread recognition that the USDA has failed badly in its responsibilities to police and enforce the rules that do exist. These persistent failures are the object of bipartisan concern in Congress and a source of great frustration to farmers and ranchers who look to the Department to protect their interests.

The current staffing and structure of enforcement almost ensures that little will be accomplished. There is a disjointed structure to the USDA's own enforcement efforts. GIPSA deals with meat and grain. Another part of the Department deals with cooperatives and still others focus on market information.[37] The GIPSA division charged with enforcing the PSA is largely staffed with economists and not lawyers. It lacks the authority as well as the staff to initiate actions. Instead, proposed cases must be referred to the general counsel's office that itself is seriously understaffed and appears to require that any matter be re-investigated before

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[36] For a very good discussion of the definition of fairness, see Michael Stumo, Douglas O'Brien, Antitrust Unfairness vs. Equitable Unfairness in Farmer/Meat Packer Relationships, 8 Drake J. of Ag. Law 91 (2003).

[37] It appears that a full review of the organization of responsibilities for administering the market facilitation aspects of the Department's mission would be an important contribution to modernizing and making effective the implementation of competitive, fair, efficient and accessible agricultural markets.

any action is initiated. The end result is that there is very little enforcement.

In sum, despite a consistent basic legislative message concerning fundamental policy toward dysfunctional agricultural markets, the statutes lack necessary scope and coverage. Furthermore, the USDA has failed to use the powers it has to facilitate the more efficient, transparent, fair and accessible goals that underlie these statutes. Finally, its very modest efforts to enforce the existing law lack focus, appropriate organization and staffing. The result is that the law has had little positive impact in nudging markets for agricultural products toward more socially desirable conduct.

IV. Reform of the Law and Its Enforcement: An Idealized Vision of Legal Reform for Agricultural Marketing Regulation

When Congress embarked on a major review of agricultural policy in 2002, there was active advocacy for including a title on competition issues. This might have lead to an effort to revise and restate the law governing agricultural product markets in ways that are more applicable to modern conditions and provide for more general coverage of the basic policy principles found in those laws. The proposal also included efforts to identify the means for effective enforcement of these regulations through an appropriate combination of public and private mechanisms. Not surprisingly, it encountered major opposition from those on the buying side of these markets. It was eliminated in the Senate committee in favor of seeking more immediate economic gains for specific agricultural interest groups.

In its place, the Senate adopted a proposal to prohibit packer ownership of livestock and a revision of the PSA to cover current hog raising contracts. The "packer ban" is the current flash point of popular farm concern.[38] Such a focused constraint on the process of procuring livestock would probably have only limited significance, but it was fought bitterly by the major meat packers and their farm allies who currently benefit from the differential price advantage accorded captive suppliers. Although the packer ban was twice approved in the senate, it was deleted in conference.

Implicit in the analysis of antitrust law and market specific regulation of agricultural product markets is an agenda for reform. In the case of antitrust, most reforms can only be accomplished through internal changes in enforcement and policy interpretation. But Congress can play a role in spurring those changes. The one exception is changing the law about the right of indirect purchases to claim damages under the antitrust law for their injuries. In the area of market specific regulation, both ideal reform and the politically more practical specific reforms require Congressional action if they are to happen.

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[38] For a discussion of the merits and politics of this proposal, see McEowen, Carstensen & Harl, The 2002 Senate Farm Bill: The Ban on Packer Ownership of Livestock, 7 Drake J. of Ag. L. 267 (2002).

A. Making Antitrust Law Relevant to Agricultural Product Markets

As the earlier analysis showed, a central problem in antitrust enforcement is the lack of clear standards specifically related to the risks posed by monopsony and buyer power. Current guidelines for enforcement of the antitrust law either do not discuss these issues at all or do so in the most abbreviated and cursory fashion. This is most troubling in the area of merger enforcement because this is the field where antitrust law has the greatest potential to limit the harms that concentrated buying power can create. It is evident that buyer power can create anticompetitive potential even if the share of buying market is modest. In addition, the effects of buying power can occur in markets remote from the selling market on which the government is likely to focus in doing its traditional analysis. Similarly, the incentives for and harmful consequences of collusive and interdependent conduct in concentrated buying markets are different from those in comparably structured selling markets.

If buyer power guidelines are created, this will focus enforcement and ultimately lead the judicial system to take into account these concerns in both public and private litigation.

The second imperative is that the government antitrust law enforcers, both the Antitrust Division and the FTC, need to be more active in enforcing both merger and restraint of trade law. It is offensive to hear spokesmen from the Division say to farmers that they must come to Washington with a ready made case before the Division will do anything. The government has the resources, skills and legal power to conduct effective investigations. The problems with cheese, turkey, beef, hog, milk, and grain marketing practices are known and visible. Each involves real potential that the conduct involves collusive or monopolistic behavior having clear anticompetitive effects. But in none of these cases, so far as I know, has the Division or the FTC even conducted an investigation. Certainly, except for a few merger cases, neither agency has initiated any litigation. This is a woeful record of inaction.

Third, it may be time to repeal the *Illinois Brick* limitation on indirect purchaser claims under federal antitrust law. The growth of state law based cases has caused even defendants to look with greater favor on focusing all claims, direct and indirect, in a single court. Without the repeal of the indirect purchaser bar this can not happen. As discussed earlier, such a repeal would be particularly important to private actions challenging abuses of monopsony power.

Finally, there is a great need for much greater transparency concerning agency decisions. It is very troubling that the public can not learn why the Division choose not to challenge the Farmland's acquisition or what the bases were for its settlement in the Suiza-Dean merger that created a single firm controlling 30% of all fluid milk purchases in the country. Because we do not know why the agency made these decisions, we can not as effectively criticize the specific action. Representatives of the agency can piously claim that it considered any issue that is raised. As a critic of the observed end result, I do not in fact know whether the issue really was considered, what facts were found, what standards were used for determining the merits of the issue, or the standard of proof imposed on factual claims. Worse, if I do not know, neither do

members of Congress who must oversee the actions and decisions of the Division to ensure that it is carrying out its mission appropriately.

This committee can insist on fuller disclosure of the reasons for actions and for inaction. It can command that representatives of the agency set forth their enforcement standards and policy for the analysis of buyer power. It can then invite scholars and practioners to review and comment on those decisions, standards and policies. In this way, it may be possible to make the Division more forthcoming as to its present activities and, perhaps, induce it to take steps toward improving its policies and stepping up its enforcement.

B. Reforming Agricultural Market Specific Regulation

1. The Ideal Response: A Comprehensive Statute with Effective Enforcement

The broad public policy of Congress, consistent across a wide range of specific pieces of legislation, is to facilitate a transparent, accessible, open, and fair, competitive market in agricultural products. Dominant firms gain strategic opportunities from ill-defined market situations. They have the resources and incentives to impose their own, self-serving order on such contexts. The public market will wither under such an onslaught. Moreover, strategic behavior will play a major role in defining contractual relations that will arise out of the ruins of the public market. Hence, legislation and regulation become essential antidotes. The underlying model of the workably competitive market that motivates and informs antitrust law provides useful guideposts, but, as discussed earlier, antitrust alone can not provide the necessary facilitating regulation essential to overcoming the dysfunctional aspects of contemporary agricultural product markets. Moreover, implementation of these policies requires a public agency ready, willing and able to act.

The basic structure for public policy is clear:

1) regulation should facilitate efficient market transactions whether in transactional markets or through longer term contractual relationships;

2) it should limit the opportunity for strategic behavior to reduce the incentive to engage in unfair or discriminatory conduct;

3) it should require open access to all major methods of buying agricultural proudcts whether those are transaction or contractual in character;

4) it should mandate full and timely disclosure of relevant information to all market participants.

The first element is the most important. The testimony of Professor Koontz to the Senate Agriculture Committee concerning livestock markets provides a useful illustration of the kinds of

actions required. He suggested that the USDA needs to be much more pro-active in developing new grading standards and certification systems so that the transactional market can provide a place in which buyers can readily find the kind and quality of animal that they sought.[39] It is not enough he points out to be concerned with bad practices, the government must be take the initiative to modernize the spot market and related market transactions to facilitate desired transactions.

This point applies generally. Government must take the initiative to facilitate workably competitive, efficient market contexts. Public markets in agricultural products have not and will not happen on their own in equitable and fair ways. The powerful economic interests of buyers at stake in these markets will shape them to serve those interests. The role of government is to restore the balance and facilitate the equitable development of the market.

Second, the law should minimize or eliminate the unfair, strategic, inefficient conduct of powerful buyers. In a lawless market, economic power is unchecked. That which is rational for individual, powerful economic actors is not necessarily fair to the parties on the other side of the transaction or, more importantly, in the best long run interest of economic efficiency. The best method for achieving this objective is to limit the ability of dominant buyers to select terms and impose conditions in their buying programs. The adoption of standard forms for transactions, public disclosure, and significant sanctions for violation of the standard procedures make it more costly for a dominant buyer to seek to engage in strategic behavior. This element also should include safe harbors that define acceptable terms that may in fact be rational elements to an efficient contract.

Third, open access to the market is another essential element. As buyers move away from reliance on spot markets in which sellers can easily participate by shipping livestock or other commodities to the market, they have the capacity to pick and choose among specific suppliers in ways that can be harmful to the supplier. If the buyer finds the open, public spot market unacceptable, then the contractual or other transactional market context needs to be defined in a way that gives all willing sellers equal opportunity to participate. The goal is to ensure that all producers have the ability to compete for forward contracts to supply livestock, milk or grain, and that the pricing is done in a way that limits the capacity of the buyer to manipulate price by its future transactions. Although the access rights would have to be product specific, the same fundamental goal should govern the regulatory process. Such reforms also reduce the scope for strategic conduct by buyers.

Fourth, information disclosure needs to be a central policy objective. As discussed earlier, dominant buyers have in many circumstances strong incentives to conceal or even misstate their buying activities. Recent legislation has sought to require more disclosure of buying information with respect to livestock. Not surprisingly, it was vigorously resisted by the

[39] See statement of Professor Koontz to the Senate Agriculture Committee at its hearing on April 27, 2000.

packers and the resulting disclosures are of limited value because they exclude information from the most highly concentrated markets. Yet these are exactly the ones where full information is most needed and least likely to be provided absent government regulation. In an idealized world the law would command that all such information be provided to sellers.

This idealized reform could be accomplished through a foundational statute analogous to the PSA. It would establish broad goals for agricultural market processes: transparency, fairness, access and efficiency. This authorization would include rule making authority so that the activity and product specific regulations could be adopted along with an effective set of incentives, public and private, to adhere to the regulations.

New legislation with broad rule making authority is necessary for reforming agricultural product markets, but it is not sufficient. There must also be a willingness to use the authority to develop rules and enforce them. The current structure of the USDA disperses the market facilitation responsibilities among a variety of bureaus and administrative divisions. This makes it much harder to achieve a coordinated reform program that takes account of the interaction among the various elements of the legal system that can and should facilitate efficient and effective markets. The same problems exist on the enforcement side. An idealized reform would clearly have to create a new and more workable structure for developing regulations and enforcing them. Perhaps Congress should transfer these duties to an independent agency or assign them to the Federal Trade Commission.

This ideal would not resolve important problems in agriculture. There would still be the potential for excess production especially when subsidy is keyed on output. Effective market facilitation would not address directly the serious problems of pollution of water and air resulting from very large feedlots for hogs and cattle or from the vast herds of dairy cows established in the west. These issues involve other aspects of the economic process. The distribution of subsidies in the form of direct payments as well as in the allowance of externalizing costs illustrates a different level of the economic issues arising from agriculture. Who gets a subsidy on what basis will strongly effect the options for economic success in any branch of agriculture. Similarly, if operations with large numbers of animals are not required to compensate for the burdens they impose on adjacent property and the harms they impose on water and air quality, that will significantly change the economic calculus for investors deciding on the scale and type of animal operation in which to invest.

2. Incremental Improvements

Congress and the members of this committee should not wait, however, for the kind of ideal solution that I have just suggested. While I remain hopeful that the continued crises in agricultural product markets will induce a stronger legislative response, realistically that is going to take a long time and great deal of consensus building. By then, so much of our farm community may have been lost that the remedy will arrive too late to salvage a viable family farm system. Hence, it is important to proceed with more focused legislation until such time as a

more global reform becomes possible.

Two specific focused proposals deserve particular attention. First, S. 91 offered by Senators Grassley and Finegold would prohibit arbitration clauses in livestock supply contracts. The parties could of course agree to arbitration at the time a dispute arose, but recourse of the courts would be available as well. While this legislative patch is limited to livestock contracts, it is of great importance because it will give farmers and ranchers greater opportunity to protect their rights by access to fair and open legal process. It is more absolute than my idealized response, but the failure of the USDA to use its existing powers to impose a more nuanced solution makes such categoric legislation necessary. Congress is not in a position to write nor is the USDA prepared to interpret and enforce a more complex regulatory scheme.

Second, S 1044 proposed by Senator Enzi and others would regulate the use of supply contracts, limited once again to livestock markets. Hereto, the statute is a patch made necessary by the failure of the Secretaries of Agriculture of both parties for many years to use the power conferred by the PSA to develop fair contracting rules for livestock and poultry markets. I prefer this proposal to the so-called "packer ban" because that ban did not address the most important concerns which are with the contracting and captive supply activities of the slaughter houses.

Both of these proposed patches to the PSA are good ideas and should be adopted. They are both limited to livestock and so fail to provide protection or facilitation to the more general process of contracting that is expanding in all agricultural markets. These limitations highlight the need for a more comprehensive approach to facilitating fair, open, transparent and accessible markets in all agricultural products.

Conclusion

Monopsony power in agriculture is a growing threat to the operation of agricultural product markets. It is vital that the law be used to both limit the growth of this power and to regulate its use. Both consumers and producers will be better off if both antitrust law and market specific regulation are directed at the problems that have arisen in this area. It is my hope that the members of this committee will use their influence both to bring about legislative change and to insist on more active and effective enforcement of the existing laws that address these problems.

Milk Market Channel Structure: Its Impact on Farmers and Consumers, and the Inadequacies of Antitrust Enforcement as a Foundation for Dairy Policies: Evidence from the Northeast Dairy Industry

October 30, 2003

Testimony

Monopsony Issues in Agriculture:
Buying Power of Processors in Our Nation's Agricultural Markets

Judiciary Committee, United States Senate

by

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Milk Market Channel Structure: Its Impact on Farmers and Consumers, and the Inadequacies of Antitrust Enforcement as a Foundation for Dairy Policies: Evidence from the Northeast Dairy Industry

I. Introduction

The U.S. dairy industry involves more than consumers and dairy farmers. Dairy cooperatives assemble and market their member's milk. The nation's dominant dairy cooperative, Dairy Farmers of America, has a strategic alliance with other cooperatives, Dairy Market Services, which in turn has a full supply contract with the nation's two largest fluid milk processors, Dean Foods, and National Dairy Holdings. Fluid processors and the retail distribution system, most notably large supermarket chains, have recently become extremely powerful players in milk market channels. This is well known to anyone who follows issues in the industry, however, virtually all of the economic analysis of federal and state dairy policies assumes that dairy market channels are competitive.[1]

Moreover, or perhaps as a consequence of the constrained analytical approach, resulting dairy policies are almost exclusively based upon competitive channel assumptions. Alternatively dairy policy makers have ignored the implications of departures from competition on policy construction and policy impacts. As this testimony will demonstrate this omission has had a particularly damaging impact on the Northeast and especially New England.

In the political arena the competitive channel assumption provides cover for milk channel firms who recommend the virtues of competition to farmers. By assumption, channel firms are competitive so their conduct escapes scrutiny and the debate focuses on dairy policies as distortions in an otherwise competitive industry. This is a most inaccurate and unfortunate framing of dairy pricing problems.

[1] See for example Jesse et al (2002) and Balagtas and Sumner (2003).

The importance of antitrust enforcement in the fluid marketing channels should now be clear. If vigorous and effectively competitive conditions prevail then these "Chicago School" competitive market models of agricultural production and food marketing channels have more standing.[2] However, we submit that in several areas of the country, dairy farmers have been the victim of a pincer movement in policy. Dairy policies have been relaxed to allow market forces to determine farm level milk prices. For example, when discussing federal fluid milk market orders, Jesse et al. state that fluid milk market orders should,

> "Allow competitive forces to determine effective prices. Administered federal order prices are designated as minimum prices. If the cost of supplying fluid milk relative to supplying manufacturing markets is greater than the Class I differential, then cooperatives can and do obtain premiums to cover the difference and raise the effective Class I price to a competitive level" (Jesse et al, 2002, p. 23)

At the same time antitrust enforcement has failed to challenge successfully horizontal mergers and vertical strategic alliances in many regional milk marketing channels including New England. Consequently, we now have very few, large, and interconnected firms in many regional and local dairy market channels. In regions where this is the case and the federal order minimum prices for fluid milk have been lowered to make room for competition, competition can be subverted by powerful buyers that leave fluid milk prices below competitive levels.

[2] Over the past 70 years economists have offered other cogent rebuttals, alternative models of industrial organization if you like, to this textbook competitive market characterization of agricultural production and food marketing channels. Agricultural commodity and market regulatory policies are needed, and in many instances efficiency enhancing because:

- Agricultural production is an uncertain biological process subject to the vagaries of disease and weather.
- There is an over production trap in farming due to high fixed costs and decentralized production units.
- Rapid technical progress produces a treadmill effect. Farmers that are slow to adopt technology lose.
- Production is seasonal, subject to longer run cycles and price instability.
- The product is fresh, and you must sell it or smell it so farmers are susceptible to "hold ups" in the market place.
- Food safety is a concern.

The promoters of increased concentration in processing and retailing have claimed that economies of size bring cost efficiencies that result in lower consumer prices. Empirical evidence paints a stark and different picture. In New England, the Pacific Northwest and elsewhere, supermarket fluid milk prices are extremely high when compared to raw fluid prices and processing and retailing costs (Rabinowitz et al. 2003, Cotterill et al. 2003, Robinson 2003).

In this paper we will illustrate how the dairy policy and fluid milk pricing problem has changed in the New England fluid milk channel since the mid 1990's. We will do so by explaining how the structure of the New England fluid milk channel has changed, how fluid milk policies have changed, the interaction between policy and channel structure, and the impacts on farmers, channel firms, and consumers. A central theme to this narrative is the interplay of public and private market power with their impacts on raw fluid and retail fluid milk prices.

We will demonstrate that milk pricing has changed and channel firm net profit margins have widened as channel concentration has increased. The case study also strongly suggests that market power is being exercised against farmers in the Northeast via low over-order premiums as well as against consumers in Southern New England via higher retail prices.[3]

II. The Inadequacy of Antitrust Enforcement: Rising Concentration and Vertical Strategic Alliances in the New England Milk Marketing Channel

Since 1996, several major structural events occurred in the New England supermarket and fluid milk processing industry. In this section we will document changes in market structure at the supermarket, processing, and milk assembly stages of the fluid milk channel. We also will

[3] The current situation is virtually identical in the Pacific Northwest. See Rabinowitz et al. for analysis. Chicago has also experienced noncompetitive fluid milk pricing. Minneapolis has high retail prices relative to costs, as do many other areas, that merit investigation (USDA, 2003a)

review salient antitrust actions, explain how antitrust enforcement was inadequate, and offer some observations on current antitrust issues.

II.1 The Increase in Concentration in Supermarket Retailing in New England

The watershed merger for the diminution of supermarket competition in Southern New England is the Royal Ahold acquisition of Stop and Shop in 1996. Stop and Shop was, and is today, the leading supermarket chain in Southern New England. Royal Ahold/Edwards supermarkets was the number two chain in many local markets in Southern New England. The Federal Trade Commission (FTC) and the Massachusetts, Connecticut, and Rhode Island Attorney Generals adopted a fix it strategy and negotiated a major divestiture of 31 supermarkets with sales of over $600 million to smaller competitors in an attempt to preserve competition.

As an economic expert for the states, the lead author of this testimony provided the market area analysis and negotiated with the FTC and parties in this matter. We created Adams Supermarkets, a new local supermarket chain owned by Bozzutos Wholesale, Cheshire, Connecticut; divested stores to Shaws Supermarkets, a new and expanding entrant into Connecticut, to Ro-Jacks, a 5 store independent in Providence, and to others. Royal Ahold converted all its remaining Edwards to Stop and Shops.

In retrospect, the antitrust agencies should have challenged this merger rather than attempt to fix it via divestiture.[4] An extensive ex post analysis of pricing in many of the divested stores (Cotterill et al, 1999) supports this conclusion. The operators of the divested stores competed on price for several months, however, when Stop and Shop retaliated with lower prices

[4] See Cotterill (2002b), Comments on the Food Marketing Institutes' Submission to the FTC Workshop Titled, "Supermarket Merger Investigations and Remedies." for a more detailed discussion for FTC divestiture practices.

in neighboring stores, after a few months of punishment, the operations of the divested stores caved in and followed Stop and Shop to higher price levels.

Ro-Jacks supermarket went bankrupt attempting to operate the five additional supermarkets that were much larger than its original five stores.[5] Two of the ten Adams Supermarkets are now closed and the chain has not grown.

Today, Stop and Shop is the unchallenged leader in Southern New England with market shares above 50% in many local "antitrust" market areas. Several other horizontal mergers, including Shaws 1999 acquisition of the Star Markets in Boston, have also contributed to the increase in supermarket concentration. Table 1 gives the market shares and four firm concentration ratios for the three aggregate IRI market areas that cover virtually all of Massachusetts, Connecticut, and Rhode Island (Trade Dimension, 2003). Market concentration and the trends to increased concentration reported in Table 1 are undoubtedly higher in smaller geographic antitrust market areas because chain stores are not uniformly distributed throughout an IRI area. Table 1 gives store numbers and market shares for the top four supermarket chains in 1996, 2000, and 2003 for each IRI area.

The Boston IRI area which is all of eastern Massachusetts except Cape Cod, is the least concentrated; however, the partial HHI (top four firms) increase from 1,325 in 1996 to 1,765 in 2003. Stop and Shop store numbers increases from 68 to 88, and its market share goes up from 26.2% to 32.8%. Shaws market share jumps to 26.7% in 2000 because it was allowed to acquire Star Markets. Note that its store numbers remained unchanged at 80 between 2000 and 2003, but it lost 4.5 market share points. The market positions of DeMoulas and Roche Brothers, two strong local chains, remained stable throughout this period.

[5] At the time, the lead author of this testimony prepared an extensive report for the Rhode Island Attorney General, that recommended Ro-Jacks not be given the divested status and predicted their bankruptcy.

The Providence IRI area is the State of Rhode Island. The market share levels and trends document Stop and Shop's dominance in 1996 and growth into an even stronger dominant position. In 2003, Stop and Shop's share of supermarket sales was 51.5 percent. Its only significant rival is Shaws with a distant 20 percent of the market. The partial HHI is extremely high at 3,120 points.

The Hartford IRI market area includes virtually all of Connecticut and western Massachusetts. Again, Stop and Shop was the dominant firm in 1996 with 60 stores and a 40.4 percent share. By 2003 it expanded to 69 stores and 49.5 percent of the area's supermarket sales. The biggest loser was A&P who exited many markets in the area. A&P operated only nine stores in 2003, down from 35 in 1996, and its share was only 2.9 percent in 2003, down from 11.7 in 1996. Some of the stores that it sold were state of the art, recently constructed superstores, and curiously some were sold to Stop and Shop. In our opinion a sale to the area market leader should not have passed antitrust muster. If Stop and Shop and the acquired A&P were not in a more narrowly defined antitrust geographic market, one should revive the potential competition argument when dominance by Stop and Shop in the region is so pervasive. Price Chopper, a New York firm that has been trying to enter New England for years, is a more suitable buyer. The partial HHI for this very large IRI area has increased from 2,021 in 1996 to 2,695 in 2003. As in Providence, this is far above the federal merger guidelines upper threshold of 1,800.

Stop and Shop routinely engages in real estate practices that are explicitly designed to protect its market position. In Putnam, Connecticut, Stop and Shop has held the lease and kept a store empty (an old Edwards store) since 1996 in a downtown shopping plaza. It also has objected to the landlord renting an empty K-Mart Store in the same plaza to Price Chopper, a

formidable competitor, on the grounds that the lease for the dark Edwards prevents any other site in the plaza from being rented to a grocery store. Such exclusivity clauses are common in leases in shopping centers; however, it is most extraordinary for a supermarket to rent and hold empty a store in a center and then attempt to exercise the exclusivity clause to keep a supermarket out of another store site in the center.

As a result of Stop and Shop's actions, the shopping plaza has died and is an eye sore in the center of town. The town's library sits in the middle of this dilapidated strip mall. Consider the impact on kids that should be using the library. Civic pride suffers. In 1999 when we surveyed supermarket prices in 19 Royal Ahold stores in Connecticut and Pennsylvania we found a strong correlation between the HHI and Royal Ahold price levels. Putnam, with a single Stop and Shop, one smaller old supermarket was the most concentrated market. It also had the highest prices of all the supermarkets that we checked (Cotterill, 1999 p.16). Stop and Shop's motive seems clear. They exclude competitors and charge higher prices.

Figure 1 and 2 provide price evidence on milk pricing at Stop and Shop in the Hartford and Providence IRI areas. Note that after the Royal Ahold acquisition, Stop and Shop's milk price moved up in both market areas and remained higher than those of all other supermarkets. The crossover occurs earlier in Hartford than Providence possibly because the acquisition was completed earlier in Connecticut than in Rhode Island where the debate over divestiture to Ro-Jacks delayed settlement several months since 1996. Stop and Shop is the price leader in Southern New England for milk and has led prices up.

II.2 The Increase in Concentration in New England Fluid Processing

Since 1972, the market structure of fluid milk processing in New England has collapsed to a single dominant firm, Dean Foods, with extensive private label processing, the Garelick fresh milk brand and other secondary brands. In July 1997, co-temporal with the Dairy Compact implementation, Suiza Dairy, the precursor of Dean Foods, purchased the Garelick Company and entered New England. In July 1998, Suiza purchased another leading New England milk processor, West Lynn Creameries; and in August 1998 it purchased yet another leading processor, Cumberland Farms. Cumberland Farms had a reputation for being aggressively competitive when bidding against Suiza/Garelick for private label contracts (Healy, 2000).[6] The Cumberland merger should never have been sanctioned by the antitrust authorities. Thereafter, Suiza purchased Natures Best Dairy in Rhode Island and attained control of New England Dairies in Hartford, CT through a joint venture with Dairy Farmers of America.

On June 1, 2000, Suiza/Garelick commenced supplying private label milk and Garelick brand milk to Stop and Shop. Prior to that, Stop and Shop processed its own private label milk in addition to processing and distributing the Hood milk that it sold in its supermarkets.[7] Moreover, Stop and Shop also controlled the marketing, including pricing of Hood milk in its

[6] Several independent industry sources corroborate this fact.

[7] This is common knowledge in the New England dairy industry. Several independent industry sources corroborate this fact. Also, one can use the USDA Health Inspection Service plant numbers that by law are printed on every container to identify the processing plant. Hood milk sold in Stop and Shop had the same plant number as Stop and Shop private label during this era. Today, Stop and Shop and nearly all other private label milk in southern New England comes from plant no. 35-100, the Dean Foods plant in Franklin, Massachusetts that also bottles Garelick and Sealtest milk.

stores (Beatty). This means that for Stop and Shop there is no question over who controlled prices on 80 percent of the milk that it sold prior to July 2000.[8]

The 15-year strategic alliance contract (Gorenstein) that ties Stop and Shop to Suiza was scrutinized and modified by the New England state attorney generals on antitrust grounds.[9] The states alleged the following:

> "the February 2000 transaction would increase concentration in the market for sale of fluid milk products in New England by reducing the level of milk processing capacity in New England that is not controlled by Suiza....Suiza could unilaterally exercise market power resulting in increased prices to retailers and consumers, and that the transaction would increase barriers to entry for Suiza's competitors and potential competitors by making it more difficult for them to obtain capital to build capacity." (Sorrell, June 25, 2001)

The consent decree provided the following resolution:

- "Suiza shall offer 30 million gallons of its New England milk processing capacity per year, for a period of five years, to its competitors. Competitors who want to utilize Suiza's New England milk processing capacity will enter into processing agreements with Suiza.
- Suiza and Stop & Shop shall not honor their past agreement to restrict Stop & Shop stores from selling competitors' milk or cream products, and shall not enter into any agreements in the future to restrict Stop & Shop stores from selling competing brands.
- Stop & Shop shall not sell the milk processing assets of the Readville plant to Suiza, and may only sell the assets to a party approved by the Vermont Attorney General.
- Suiza shall not purchase or otherwise acquire an ownership interest in any dairy processing facilities in New England without first notifying the Vermont Attorney General and allowing the Vermont Attorney General time to Investigate the proposed transaction.
- Suiza shall not sell, close or cease operations of any New England dairy plants without first notifying the Vermont Attorney General." (Sorrell, June 25, 2001)

[8] A similar situation holds today in the Pacific Northwest where Safeway and Kroger (Fredy Meyer and Quality Food Centers) operate their own milk processing plants. The benefits of high retail prices accrue entirely to the integrated chain.

[9] The lead author of this testimony served as economic expert for the states.

In a separate agreement Suiza agreed to continue purchasing its raw milk from Stop and Shop's traditional supplier, St. Albans cooperative. Leon Berthiaume, General Manager of the St. Albans Dairy Cooperative, said:

> "We appreciate the extensive efforts of the Vermont Attorney General's Office to protect the interests of consumers, farmers and processors in our state. The results of this process will prove to be beneficial to all interested parties." (Sorell, June 25, 2001)

John Kaneb, President of HP Hood Inc., a company whose products would have been disadvantaged by the agreement, also praised the settlement:

> "I congratulate the Vermont Attorney General on bringing about a result that helps preserve competition in the New England dairy industry, while allowing a commercial transaction between private parties to go forward. This is constructive antitrust policy in action." (Sorrell, June 25, 2001)

Table 2 gives an estimate of the market shares in all of New England for the leading milk processors for the year ending June 30, 2000. We have no more recent data; however, these shares are reasonably accurate today. Before the Stop and Shop private label contract Suiza/Garelick accounted for 44.8 percent of fluid milk sales to supermarkets. This is more than twice the share of the number two processor, Hood. Suiza/Garelick is nearly three times larger than Hood if one removes the Stop and Shop Hood milk from Hood's share. After the June 2000 closing of the Stop and Shop plant, Suiza controlled 63.7 percent (44.8 + 18.9) of the New England supermarket channel. This market share may have increased since then because in the 15 year strategic alliance, Stop and Shop clearly has less incentive to sell Hood milk (Baily, March 24, 2000).

After the consummation of the Stop and Shop deal, Suiza/Garelick may sell more than four times the volume of milk than its nearest competitor, Hood, sells in New England. The

Suiza/Garelick market share in the smaller Boston IRI market is even higher and probably falls in the 80-90 percent range after the Stop and Shop acquisition.

Strictly speaking, these market share estimates are for the supermarket channel; however, Suiza/Garelick's dominance in other channels is most probably similar. There are very few alternative suppliers. Also, one could include milk plants around Albany, New York in the market. Both Suiza and Crowley have plants there. Such changes do not alter the following conclusion. By 2000, Suiza was unmistakably the dominant milk processor in New England.[10]

As Suiza acquired its market share, it actually closed or caused the closure of several very substantial milk plants including the Stop and Shop Readville, MA plant, the New England Dairies plant in Newington, CT, and the Cumberland Farms-Massachusetts plant. Today it operates two large plants in southern New England in the Boston IRI market area (Franklin, MA and West Lynn, MA). Suiza's East Greenbush, New York plant near Albany and two smaller plants in Vermont and Maine also supply milk to New England. As a result of Suiza's related plant closings, by 2000 there was dramatically less processing capacity in New England and little excess capacity outside of the Suiza plant system (Healy, 2000).[11]

Suiza's rise to dominance in the New England market was associated with a visible elevation and changed pricing philosophy relative to Hood. In Figure 3, the Garelick and private label retail price moves in 1999 and 2000 that widen the marketing margin are at least in part due to price leadership by Suiza-Garelick at the processor level.

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[10] Lest one think that this dominance does not effect conduct. Industry executives now request anonymity when providing information for fear of retaliation by Dean Foods.

[11] In response to the disappearance of capacity and increased demand for an alternative to Dean Foods, Guida-Siebert Dairy, New Britain, Connecticut expanded capacity in 2001. Plant numbers on milk bottles and information from Alex Guida, president of Guida-Siebert Dairy indicate that it now supplies BIG Y, a regional chain, with private label milk.

The only other explanation for the disappearance of the gap between Hood and the other two products in Figure 1 is that retailers exclusively controlled the retail prices and priced in a fashion to generate a very significant shift in volume away from private label and Garelick to Hood.[12] In fact for the market leader, Stop and Shop, the incentive was to disadvantage Hood.

On April 5, 2001, Suiza Foods, the number two fluid processor in the nation, announced that it was merging with Dean Foods, the nation's largest processor, to create a company named Dean Foods that would control approximately 40% of the nation's fluid milk processing. In many regional fluid processing markets, but not New England, this merger created serious antitrust problems. After negotiation with the U.S. Department of Justice, Antitrust Division, the merger was consummated in December 2001. The DOJ required Dean to divest 11 fluid milk plants to three individuals and Dairy Farmers of America, who sold its 1/3 interest in Suiza back to the company. DFA and the private owners each own one half of the newly created company, National Dairy Holding (U.S. DOJ, 12/18/2001; PR Newswire, 12/21/2001). Dean remains the nation's largest fluid processor with $8.12 billion in sales in 2002, and NDH is the third largest with $2.3 billion sales (Dairy Field, 6/2003)[13]. Soon thereafter National Dairy Holdings acquired Crowley Foods (Binghamton, NY) from a Dutch multinational. In that deal, NDH entered the New England fluid market because Crowley owns Weeks Dairy in Concord, New Hampshire, and a fluid plant near Albany that can ship into New England.

[12] See Cotterill and Tian (2003) for estimation of Hood, Garelick, and private label demand curves for the Boston market.
[13] Kroger, the nation's second largest supermarket chains, is the number 2 processor with sales of $2.8 billion.

II.3 The Increase in Concentration in Fluid Milk Assembly and Vertical Relationships with Processors.

Both the National and the New England fluid milk industries are an example of the replication hypothesis, a venerable idea from industrial organization theory. As economic concentration occurs at one stage in a multistage channel, the replication hypothesis predicts concentration increase at other stages in the channel. Indeed, large fluid milk processors and large fluid milk cooperatives often assert that "the demands" of serving dominant supermarket chains that are national, or at least multi-regional in scope, has driven consolidation in fluid processing and that in turn has driven consolidation in cooperative milk assembly.

Until recently, milk assembly in New England was easily classified into three primary groups. The Agrimark cooperative was the largest player supplying milk to many fluid processors including Hood and Guida, current Agrimark customers. The St. Albans Cooperative shipped all of its fluid milk to the Stop and Shop milk plant. The third block of milk in New England was from independent farmers that Garelick, among others, had under contract. Agrimark and St. Albans supplied well over 50% of the fluid milk in the New England fluid milk market order prior to its consolidation in 2000 into the new Northeast milk market order that includes New York, Philadelphia, and Washington DC.

Today the situation is very different. It also is very unstable because of continuing instability in the structure of fluid milk processing in the region. The predecessor to Dean Foods, Suiza Dairy, was 1/3 owned by Dairy Farmers of America (DFA). Suiza Dairy had a fluid full supply contract arrangement for milk from DFA in regions where DFA offered milk. In the northeast, DFA includes the former Eastern Milk Producers Cooperative of NY. Eastern was a part of Milk Marketing Inc, Strongville, Ohio and it merged with two Midwestern cooperatives to form DFA. DFA strengthened its position in the northeast in 1999 by forming a marketing

agency in common, named Dairy Marketing Services (DMS), with Dairylea, the leading dairy cooperative in NY (Associated Press, 9/2/99). Suiza Dairy (1/3 owned by DFA at this time) then strengthened DMS by making it the milk assembly agent for its independent farmers nationwide. This included the independent farmers in New England. St. Albans joined DMS because its access to the fluid milk market via the Stop and Shop/Suiza agreement expires in 2006. Finally the NDH (50% owned by DFA) plants in Concord, NH and near Albany, NY are also under full supply contracts with DMS. In New England these moves have made DMS the major fluid milk assembler with Agrimark, a distant second.

Looking to the Northeast, Atlantic Dairy Cooperative was the supplier of as much as 80% of the fluid milk to the Philadelphia market order that was merged into the Northeast Order in 2000. It was acquired by Land O'Lakes. In August 2003 Land O'Lakes fluid milk assembly in the Northeast also joined the DMS marketing agency in common (The Business Journal, 8/4/03). DMS now supplies Dean Foods and National Dairy Holdings plants in New York, New Jersey, and Pennsylvania as well as New England. These plants are dominant in the northeast fluid market.

What are the impacts of the consolidation of milk assembly under the DMS banner? DMS promotes itself as a harbinger of efficient milk assembly, thereby lowering hauling charges and improving farmer mailbox prices.

> "Dairy Marketing Services (DMS) is a milk marketing organization formed for the purpose of creating efficiencies and reducing costs of milk assembly, field services, and transportation. It serves farmers by working to streamline the milk marketing system, and serves processors by being better able to meet their needs." (Dairy Marketing Service, 2003).

Undoubtedly these are legitimate efficiencies. But we doubt that they are more than a few cents per hundredweight. For example, nearly all of northern Vermont milk in the DMS system today

was assembled in St. Albans and that will not change. In Pennsylvania all milk in the DMS system was assembled by Atlantic Dairy/Land O'Lakes and that will not change. In upstate New York, Dairylea, DFA, and independents shipping to Dean and NDH (Crowley) may have had overlapping costs that can be rationalized. However, that gain may not be large for larger farms that can fill a tanker or a large part of a tanker.

On the other side of the accounting ledger several antitrust concerns surface. Does DMS have monopsonistic power against farmers? Does DFA have undue influence over DMS and consequently do northeast dairy farmers lose? DFA is a multinational operation with its roots in the Midwest. Also it is a "top down" organization that behaves more like a proprietary firm than a cooperative. This may have benefits, but it leads northeast farmers to question whether it represents and acts in their best interests. Does DMS have monopolistic power in the raw milk market that enables it to extract large over-order premiums from processors and retailers?[14]

These questions are very hard to answer with empirical evidence at this time because the DMS/DFA track record is very short. For insight, let's retreat to the documented structural changes in the dairy channel, the profit maximizing drive by all players in the channel including farmers via their cooperatives, and the economic implications of these two facts. Structurally we have dominant firms or tight oligopoly in nearly all local retail markets. We have dominance in many regional fluid milk processing markets and we have a dominant cooperative agency assembling milk. This means that many fluid milk marketing channel are faced with the successive firms with unilateral market power.

[14] DFA field representative (not DMS) has used the promise of cooperative power in presentation to potential member in New England. To date the primary manipulation had not been in fluid milk processing. It is the Cooperatives Working Together (CWT) program which is in our opinion, and the opinions of other agricultural economists, an ill-fated attempt to control supply. When it comes to supply control cooperatives are not as well suited as the federal government, which can eliminate free riders.

Elsewhere, we have written about the problem of double or in this case triple marginalization in a marketing channel (Cotterill 2001, 2002c). As these successive firms move to exercise market power against consumers the tendency is to elevate prices too high, damaging channel profits as well as consumers. One needs a vertical strategic alliance to internalize this pricing externality, i.e. the participants at the three steps of channel must jointly set the retail price and agree upon the division of the resulting profits. One must ask if this type of vertical price fixing is legal? Is it subject to a rule of reason test that balances market power from vertical cooperation with efficiency gains from eliminating double or triple marginalization? In other words, do these vertical strategic alliances between retailers and processors, and between processors and cooperatives create barriers to entry that enhance the partners' ability to deviate from competitive pricing? Clearly the New England Attorney General thought this to be the case in the Stop & Shop/Suiza-Dean strategic alliance.

This leads us to a current antitrust matter, the proposed merger between NDH and Hood in November 2002 (Cohen, 8/4/2003). This proposed merger would combine Hood and the Crowley Albany and Concord plants. This horizontal merger should not be allowed from the consumer's side because it reduces competition in the highly concentrated New England fluid market. A cogent argument can also be made from the farm side of the market. The Agrimark Cooperative would lose its fluid milk sales to Hood because NDH/Hood would move into the DMS/DFA full supply contract camp. This fluid loss threatens to depool Agrimark from the fluid milk market order because the coop may consequently sell less than 20% of its members' milk in Class 1. Agrimark members would then be paid lower cheese milk prices rather than the higher blend pure that include sales at the higher Class 1 price.

Due to strong resistance from the state and federal antitrust agencies and elected representatitives, NDH and Hood withdrew their merger proposal on May 12th. At that time, they announced a co-mingling of ownership rather than outright merger between NDH, Hood, and DFA. This second proposal is still under review. Again any form of interlocking directorship or management between Hood and Crowley will damage competition in fluid processing in New England.

If the combination transfers Hood fluid needs to DMS, Agrimark's alternatives include selling sufficient Class 1 milk at more distant fluid plants in the order (New York City, New Jersey) which would increases transport cost deductions for its members. The other option is to join DMS and effectively complete the monopolization of fluid milk assembly in the northeast.

If DMS in fact does achieve a monopoly on milk assembly in the northeast; will it be able to extract over-order premiums from processors and retailers? We think not. If DMS attempts to do so then Dean Foods could counter by retrieving its independent farmers and resorting to traditional pool busting pricing practices as in the RCMA era in the early 1990s in the northeast. In short, DMS can capture legitimate efficiencies, but it may be pushing on a rope if it attempts any significant over-order pricing in the northeast. This also suggests to us that in any tripartite division of profits, DMS will come up short because it has the weakest bargaining position. Processors and retailers have far stronger positions.

III. Recent Price Performance in the NY and New England Fluid Milk Marketing Channels: the Impact of Public Policies and Private Power

Events in the northeast dairy industry including changing market structures and changing federal and state dairy policies have had dramatic effects on the performance of fluid milk marketing channels. In 1991, New York passed a price gouging law that limits retail prices on

one brand of milk to no more than 200% of the price paid for 3.5% raw fluid milk. This raw price includes over-order premiums that raise price above the announced federal order Class 1 price. At that time, the New York legislature also passed a law that gave the state the authority to levy over-order premiums for farmers. This subsequent law was declared unconstitutional. In effect, downstate consumers interests received their part of the logroll, but upstate farmers were denied theirs.

Why did the NY legislature pass these two laws? Huff (2003) documents that farmers were suffering from an extended period of low milk prices and downstate retail prices remained high. The lack of effective price transmission hurt consumers who continued to pay high prices and farmers because fluid consumption did not increase. Clearly the NY legislature wanted to elevate raw fluid milk prices and eliminate price gouging by channel firms.

A similar but longer raw fluid price trough occurred between October 2001 and July 2003. Figure 4 illustrates the situation for Boston. The two vertical lines indicate the period when the Northeast Dairy Compact was in effect with its price floor at $1.46 per gallon ($16.94 per cwt). Between October 2001 and January 2002, raw milk prices measured by Class 1 plus coop premium price series, dropped 34 cents per gallon. This price fell another 22 cents by July 2003, for a total decline of 56 cents per gallon. Retail prices dropped only 10 cents. What is going on?

Agricultural economists have traditionally analyzed this price transmission problem by correlating the retail price with the farm price, controlling for changes in the prices of other impacts. The challenge to this approach is to find a good measure of other input prices. Moreover, the retail price series in Figure 4 is only for whole milk, price checked at two chain stores and one convenience store. It may not accurately reflect retail prices. Also, one routinely

does not have a wholesale price in these studies so one cannot determine margins at the processing and retailing stages of the channel.

Over the past year at the University of Connecticut we have developed a different analytical approach. In November 2002, we surveyed prices in 191 stores from 35 grocery firms located in NY, CT, MA, and RI (Cotterill et al, 2002). We found that retail milk prices in supermarkets were 59 cents per gallon lower, on average, in NY than southern New England. We were able to confirm the average milk price reported for November in Figure 4 but also provide pricing details for individual chains and types of milk.

We repeated a mini survey in March 2003 of the leading chains in Connecticut and added a critical component to our analysis. We obtained wholesale milk prices, i.e., the price the processors charge for delivering bottled fluid milk into the dairy case coolers of supermarket chains, from Dairy Technomics. This firm routinely measures raw milk prices, processing, and delivery costs for supermarket chain buyers who use the information to bargain for lower wholesale milk prices. Dairy Technomics estimates are for specific plants and for deliveries to specific chains. Dairy Technomics estimates have been verified as accurate by milk processors and by outside audit (Cotterill, 2003). For example, we found that Dean Foods delivers gallons of private label and Garelick milk from its Franklin, MA plant to Stop & Shop under its 15-year strategic alliance for the price it pays for raw milk plus 52.5 cents per gallon. Dean delivers the same milk from the same plant to all other chain supermarkets in southern New England for the same raw pay price plus 61.5 cents per gallon (Cotterill et al, 4/23/03).[15] The Dairy Technomics estimates allow us to determine the wholesale price, processor and retail gross margins.

[15] This suggests that other retailers may have a secondary line Robinson-Patman case against Dean. They do pay higher prices than Stop and Shop that probably are not cost justified. However, Stop and Shop has not used their cost advantage to damage the other chains. They have exercised price leadership, elevating retail prices so a R.P. suit fails because the plaintiffs are not damaged.

Our results for March 2003 are reported and discussed elsewhere (Cotterill et al, 4/23/03, Cotterill, 2003). Appendix Figure 1 to this testimony displays chain and brand level prices for March 2003.

In June 2003, in cooperation with the NY Attorney General, we conducted an extensive survey of New York and a replication of the November survey. We also obtained processor costs by plant for delivering to different supermarket chains from Dairy Technomics. Price survey results are reported in Rabinowitz et al (2003). Also see the Cheese Reporter article attached in Appendix B for an excellent review of results. This week (October 26-31, 2003) we are again surveying the same stores and obtaining Dairy Technomics estimates for the processing stage.

This series of surveys over a year where, as documented in Figure 4, farm prices were low, continued to fall and recently increased dramatically will allow us to analyze channel margins over time and changes in them as well as retail prices as farm price changes. Moreover, we can analyze changes under the price gouge law in NY and compare them to New England where there is no such law. We also can analyze price changes by brand in each of several firms including some who operate in NY as well as New England.

Since we have not had time to analyze the October 2003 data, we focus on June 2003 prices and a comparison to November 2002. The weighted average all milk price for supermarket chains in New England in June 2003 averaged $3.01 per gallon, the same as we found in November 2002. By comparison the average price for supermarkets in NY was $2.31 per gallon, down 11 cents from their November 2002 price. Two major conclusions follow. First, milk is 70 cents per gallon cheaper in the surveyed NY area (Long Island, metro NY city and the Hudson river valley up to Albany) than in southern New England. Second, when the raw

fluid price dropped eight cents a gallon in Boston retail prices did not drop in New England but they did in New York. We concur with Huff (2003). The NY price gouge law improves farm to retail price transmission.

Table 3 reports all milk prices for individual chains in NY and in New England. Note that Stop & Shop charged $3.21 per gallon, up 3 cents from November in New England, whereas in NY the chain charged only $2.45 per gallon, down 14 cents from November. One observes similar differentials for other chains that operate in New England and New York. Wal-Mart however is an exception. Wal-Mart charged $2.54 per gallon in June 2003 in New England down 25 cents from its November 2002 price. Wal-Mart appears to have responded to our call for lower milk prices in New England (Cotterill, 2002a). Wal-Mart prices in NY are lower at $2.10 per gallon, however they dropped only 5 cents from November 2002.

Figure 5 is the most important chart in this testimony. It gives the raw milk prices by brand for each of the top four supermarkets in southern New England. It also gives the Dairy Technomics wholesale dollar margin for each brand. The sum of the processor margin and the raw milk price is the wholesale price for milk delivered into the coolers at the chains stores. Finally, Figure 5 gives the retail dollar margin and the retail price by brand for each of the four chains.[16]

The first column in Figure 5 is the all milk average for southern New England. Processors paid farmers $1.031 per gallon and collected 59.6 cents per gallon for processing and distribution of milk to supermarket chains. The average wholesale price was $1.627 per gallon. The average retail milk price is far higher–$3.07 per gallon. Supermarkets kept $1.447 per gallon, nearly half of the retail price for in store costs and profits. Research at the University of Maine and Penn State University indicate that in store costs for large chain stores is as low as 20

[16] See Rabinowitz et al (2003) for survey details.

cents per gallon and ranges up to 40 cents per gallon in smaller supermarkets (Pennsylvania Milk Commission 2000, Maine Milk Commission 2002). We conclude that these large supermarkets are charging on average at least a dollar per gallon more than they would be able to charge in a competitive market channel. Note that the overcharge varies by brand and by location. Private label milk is lower priced and DeMoulas has distinctly lower prices than the other chains. DeMoulas retail margins are far lower than margins in the other chains.

Figure 5 also reveals a very extraordinary relationship between retailers and processors. Hood, Garelick, and Guida have developed their branded milk products, but the retailers are capturing virtually all of the brand equity. Examine, for example, Hood milk that is sold at Stop & Shop. Hood charges Stop & Shop $1.69 per gallon at wholesale and keeps only 66 cents after paying farmers $1.026 per gallon. Stop & Shop adds $1.82 per gallon and retails the Hood milk at $3.51 per gallon. Again, the in-store cost of selling Hood milk is less than 40 cents per gallon. Thus, Stop & Shop is capturing a hefty premium, virtually all of Hood's brand equity. The same is true for the other two brands of milk, Garelick and Guida, in Figure 5.

Now let's restate these prices on a per hundredweight basis to focus on the issue of price enhancement via public policy (i.e. the milk market order) versus price enhancement via the exercise of private economic power in the channel. At $3.07 per gallon consumers are paying $35.70 per cwt for fluid milk. Processors are paying farmers $1.031 x 11.6279 gal/cwt = $11.99 per cwt for this milk. (Since much of the milk is skim/low fat, this pay price does not include excess cream.) A recent FAPRI study suggests that eliminating the federal market orders would reduce processor pay prices by roughly $1.50 per cwt (Brown). This elimination of "public power" pales in comparison to the $1 per gallon x 11.6279 gal/cwt = $11.63 per cwt market power premium that supermarkets are extracting from consumers.

Private economic power and excess milk profits outweigh federal market order price enhancement by a ratio of 7 to 1 in New England. Those who think doing away with federal market orders would benefit consumers and farmers in low fluid utilization areas (e.g., upper Midwest) due to lower retail prices and increased fluid milk consumption need to think again. The primary beneficiaries of order deregulation may well be processors and retailers.

Moreover, the use of private power in the channel is destroying the economic basis of the orders. Retailers will elevate milk prices until the demand for milk becomes elastic, i.e., the percent decline in milk sold is greater than the percent increase in price. When milk prices are elastic the Class 1 price discrimination scheme of the federal orders <u>reduces</u> rather than increases the blend price that farmers receive. At that point, private economic power completely destroys the classified pricing system of the federal orders.

IV. The Impact of Market Power on Northeast Dairy Farmers

A critical question remains for analysis. Is the margin enhancement due to the exercise of market power against consumers or is it also due solely to the exercise of market power against northeast dairy farmers? We can actually answer this question by referring to the Jesse et al quote at the beginning of this testimony and the related federal market order reforms that occurred during the 1990s. Class 1 differentials were reduced, effectively leveling the geographic impact of the market order system's price discrimination scheme. Today, Class 1 milk at the Eau Claire, Wisconsin basing point is \$1.70 per hundredweight over the manufacturing milk price. This amount is the price discrimination component (assuming no higher costs for supplying fluid) that is common to all federal milk market orders. This Class 1 differential increases as one moves east until it is \$3.25 per hundredweight in Boston. If the

manufacturing milk price is \$9.75 per cwt, as it was in June 2003 then the Class 1 minimum in Wisconsin is \$9.75 + \$1.70 = \$11.45 per cwt and it is \$9.75 + \$3.25 = \$13.00 per cwt in Boston. Jesse et al calls the geographic components of the Class 1 differentials "pricing distortions" and states that these are now so low that competition sets regional milk prices:

> "...competition has operated both within and outside the orders to mitigate the effect of these pricing distortions. For example, low Class 1 differentials in Wisconsin are augmented by large over-order Class 1 price premiums negotiated by cooperatives. Cooperatives premiums are relatively low in other markets and nonexistent in some. This tends to equilibrate effective Class 1 prices, even though the order minimum prices may be distorted. ..." (Jesse et al, 2002 p.21)

Since manufacturing milk prices are identical in Wisconsin and Boston, any geographic federal order distortions disappear when fluid market prices set by over order premiums. This means that the reported mailbox prices for Wisconsin and the northeast, i.e. the prices that farmers actually receive for their milk are geographically competitive prices that reflect the supply and demand for milk throughout the nation.

Let's look at those mailbox prices for Wisconsin and the northeast. Table 4 reports them for 2002 and the final seven months of 2003. In 2002 the Wisconsin mailbox price averaged \$12.02 per cwt whereas in the northeast it was LOWER at \$11.89 per cwt. For 2003 to date they are essentially equal but in July 2003 the northeast mailbox price at \$11.63 was 63 cents LOWER than the Wisconsin price, \$12.26.

In a geographically competitive raw milk market, the mailbox prices in the northeast should be higher not lower than those in Wisconsin. As one moves east from the Midwest prices should rise by the transportation costs. They do not.

Alternatively, northeast milk prices at \$11.89 per cwt are clearly below the cost of production for virtually all dairy farmers in the region. If a number of them go out of business and one has to haul milk or dairy products from Wisconsin, one will have to pay farmers there

$12.02 per cwt or more for their milk and also pay the transportation cost to the northeast. Milk and dairy product prices in the northeast will be higher not lower as northeast dairy farmers go out of business and product comes in from Wisconsin.

Jesse et al state that in "deficit milk markets":

> "... Setting minimum prices at levels that promote year-round local fluid milk self-sufficiency is inefficient relative to setting prices that result in a combination of local production and shipments from other markets. ..."

We disagree with this presumption for the northeast given current market conditions. As our farmers go out of business, milk and milk products from the Midwest will cost consumers more not less.

So why are mailbox prices less in the northeast than the Midwest? The answer is that retailers and processors in the northeast are not paying over-order premiums that are as high as those in the Midwest. Also cheese plants in the northeast are not paying premiums that are as high as the cheese milk premiums in Wisconsin. Northeast raw milk markets, relatively speaking, are dominated by the milk channel firms at the expense of the region's dairy farmers. Monopsony power the northeast dairy markets is a major force.

Professor Jesse from the University of Wisconsin understands this situation. As reported in a recent Cheese Report article he recognizes that Wisconsin farmers have benefited from cheese premiums as well as over-order Class 1 premiums. He also recognizes that it may be hard to maintain cheese premiums in the face of the expansion of cheap milk in the far west and new cheese plants out there.[17] Among others he sees the following solution: a shift up from 10% of

[17] Northeast farmers have often been admonished for wanting higher Class 1 prices because they would contribute to over production of milk. Jesse et al (2002) and many others make this link. Consider the following facts. In 2002, there were 255 thousand dairy cows in New England, down 7 thousand cows from 2 years earlier. During the same two years, California, Idaho, and New Mexico EXPANDED their herds by 220 thousand cows (USDA, 2002 and 2003b). Higher fluid milk prices in New England would have virtually no impact on the national supply situation. The problem is in the west and must be dealt with there or at the federal level.

Wisconsin cheese production in value added specialty cheeses where the premium can be maintained and the capture of more of the east coast fluid milk market (Mueller, Sept 12, 2003).

> "Jesse leaves the door open, however, for the possibility that Wisconsin's average milk price will not be lower relative to the national average. For that to happen, …, milk production would have to continue to fall in the East in order to open that market there for fluid milk from Wisconsin, and the state's dairy processing industry would have to shift significantly from the production commodity cheese to more specialty cheeses (about 10 percent of the state production now)" (Mueller 2003).

On the scope of fluid milk markets Jesse et al clearly think the market is now national. They state:

> "Recognize the national scope of fluid milk markets. Policies need to recognize that dairy products – including fluid milk – trade in national markets. The concept of a local milkshed became obsolete when grocery chains began to maintain national distribution systems for both perishable and nonperishable items." (Jesse et al, 2002)

Dairy processors also think this way.

> "By pasteurizing and homogenizing, and blow molding and filling bottles in a sterile environment, Dean now produces milk-based drinks that don't require refrigeration and can sit on a shelf for 150 days. Instead of delivering directly to stores, Morningstar can ship drinks through a network of warehouses and sell them in soda aisle of grocery stores. At $12 million per filling line (which can do 18,000 bottles per hour), the technology doesn't come cheap. But, as Engles points out, 'somebody was going to do this. We're trying to be first.' And, of course, biggest." (Cook, 2003)

One should regard this trade puffery with a strong dose of skepticism.[18] We would stress that the national fluid market that Jesse et al and Dean proclaim is <u>not here yet</u> and may never be the predominant fluid milk market structure. Fresh milk is still in most situations produced reasonably close to where it is consumed, and we would maintain that a low cost supply of fresh milk in the northeast will continue to be produced for the foreseeable future in the northeast.

[18] In 2000, a top Suiza Dairy executive regaled a conference of agricultural economists with grand predictions for their new milk products, "Kids Milk" and "Life Milk." These products were to appeal to moms who wanted to get more calcium, and vitamins into their kids and young adults. At over $4.50 per gallon they have been noticeably unsuccessful.

V. Antitrust Policy and Dairy Policies Need to Address the Low Raw Fluid Milk Prices in the Northeast

What does the rise of private pricing power in the dairy marketing channel suggest for dairy policy? We think there are two avenues. First at the federal level one could restore Class 1 differentials to levels that limit the exercising of channel firms power against farmers. After all one of the original reasons for establishing market orders was to countervail channel firm market power and restore "orderly" marketing to the milk industry. Alternatively, regional milk pricing policies in areas where this problem exists are in order to elevate farm prices.

Antitrust enforcement that prevents further consolidation also is a good idea. But in many regions, shutting this door does no good because the horse is already out of the barn. Recently, in Chicago, a consumer class action lawsuit against the dominant supermarket chains, Jewel and Dominick's failed because the price leadership scheme they use is not price fixing. Jewel sets a high price. Dominick's and others match that price. Since no one talks (conspires) with others to set the price, their conduct is legal (Zimmermann, 2003).

When antitrust is ineffective, economists look to regulation to improve economic performance. The New York price gouging law limits retail price to no more than 200% of the raw milk price processors pay. Prices, on average, in New York are 70 cents per gallon lower than in New England. New England states are now considering such laws, but these only benefit consumers.

Another alternative is a price collar at the processing as well as retail level; as was recently proposed in Connecticut (Cotterill et al 2003).[19] A 140% price collar on the wholesale

[19] See Appendix B, *Cheese Reporter* article, "Controversy Over Level Of Farm Versus Retail Milk Prices Continues" and "A letter to the editor in response to the "Controversy Over Level Of Farm Versus Retail Milk Prices Continues" for more explanation of the price collar proposal.

price provides an incentive for processors to pay higher over-order premiums to farmers. Alternatively, they lose money along side farmers in low raw price markets. Processors need 60 cents per gallon to cover their costs. At $1.00 per gallon raw milk price they can charge retailers only $1.40. If they pay farmers an additional 50 cents, then the raw price is $1.50, and they can charge $2.10 and recover the 60 cents. Placing a 130% price collar on retailers means retailers can charge up to 1.3 x 2.10 = $2.73 per gallon. Consumers pay 34 cents per gallon less than $3.07 per gallon, and farmers gain 50 cents per gallon. Given that farm milk prices are severely depressed, this reallocation of income in the channel may be appropriate.

The bottom line is this. Vigorous antitrust enforcement is important, but it may be time for policy makers to re-examine fluid milk channel pricing and to consider new approaches to dairy policy. One has opportunities to argue for regional milking pricing policies that promote dairy farming in regions such as New England by promoting more <u>efficient</u> as well as more <u>fair</u> milk market channel pricing. Doing so also preserves the effectiveness of classified pricing under the federal orders.

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OPENING STATEMENT

Committee on the Judiciary
"Monopsony Issues in Agriculture: Buying Power of Processors in Our Nation's Agricultural Markets"
October 30, 2003

I will start by welcoming our distinguished panel of witnesses here today to discuss an issue that is very significant in American agriculture. We are here to discuss the marketplace in which nearly two million U.S. agricultural producers operate. Those two million are directly responsible for feeding you, me, this country and in many instances, the world.

First, I think it's important to recognize that enhanced and advanced communication systems and technology have heavily contributed to a more integrated world. Our economy faces increasingly stronger global influences and market forces. New economic relationships and the United States' resources and leadership in building these relationships around the globe have set the stage for the opportunities and challenges that our domestic industries now encounter.

In the agricultural industry, this is particularly true. The agricultural sector is unique and involves very complex economic models and relationships when compared to others. I believe no other industry faces the same degree of uncertainty and risk that those roughly two million producers and their families encounter on a daily basis.

It is this uniqueness and attention to risk in our agricultural industry that brings us here today. Agricultural producers are desperately trying to operate in a marketplace that demands low end-use prices, yet high quality through increased efficiencies; and how to increase producer profitability, although subjected to the status of a "price taker," not a "price-maker."

It is no secret that today's domestic market, especially in the livestock and value-added arenas, has witnessed a significant shift from supplying meat cuts for consumers through farmer markets in the local town square, to shipping live cattle hundreds or even thousands of miles away to a large packing and processing plant whose products eventually reach millions.
With this in mind, it is important to note that within the U.S., markets differ

significantly by region. In the Northwest, our producers must ship their crops or livestock through limited means to markets that are few and far between. The traditional sales-yard is still prevalent, but becoming rarer. In contrast, areas such as the Midwest contain vastly larger herds that supply a much greater number of processors who may be just down the road from the farm.

Just recently one of only a few remaining packing plants in my state just closed shop, and 272 people were immediately looking for new jobs. Although this may be deemed a small operation by some standards, it represents a larger issue: that producers are becoming increasingly aware of the importance that risk mitigation plays in their operational plans. Contractual arrangements with buyers are proving more popular to combat risk, and I believe it the responsibility of those in Congress and in regulatory positions to ensure that these arrangements are fair and not exploited.

Today we will receive testimony from our panel that will explore their actions and thoughts on this issue of fairness in today's agricultural marketplace, and how the terms "monopsony" and "monopoly" adhere to this vital sector of our economy.

I hope the hearing will help shed light on the frustration that I and my colleagues have experienced – most recently in the 2002 Farm Bill – in sifting through these complicated issues. Again, welcome and I look forward to your testimony.

WORC

Western Organization of Resource Councils

Testimony of Mabel Dobbs

for the

Western Organization of Resource Councils

Thursday, October 30, 2003

United States Senate Judiciary Committee

On behalf of the Western Organization of Resource Councils (WORC), I would like to thank the Judiciary Committee for holding this hearing. I am Mabel Dobbs. I ranch with my husband near Weiser, Idaho. I am Chair of the Western Organization of Resource Council's (WORC) Livestock Committee. WORC is a network of grassroots organizations from seven states with 8000 members and 45 local community groups.

WORC appreciates the opportunity to submit testimony on monopsony power, and solutions that will restore open and competitive markets in agriculture. WORC and its member organizations have led the effort to publicize the extent of packer concentration and vertical integration, to identify the adverse effects of concentration and integration on market competition, and to promote constructive, practical policies to restore competition.

Meatpackers are acquiring an increasing percentage of the cattle and hogs they slaughter through arrangements known as "captive supplies" – livestock that packers either own themselves, or control through contracts with farmers and ranchers. These livestock are called *captive* because they are tied to one packer instead of being subject to normal market forces of supply and demand.

Four companies control 59% of all U.S. hog slaughter and 81% of U.S. fed cattle slaughter[1]. In such a concentrated market, buyers (the packers) can use captive supplies to manipulate markets – much as Enron is alleged to have used its dominant market share and unregulated forward contracts to manipulate energy markets. The estimated cost to family farmers and ranchers from the increased use of captive supplies amounts to more than $1 billion per year for cattle alone.[2]

WORC and its member groups have been working to identify problems in our livestock markets and to develop solutions since the late 1980's, when our members became concerned about the rapid increase in market concentration. The share of U.S. fed steer and heifer slaughter held by the top four packers had recently shot up above 80%. Our members, other cattle producers, and leading economists expressed concerns that such high levels of market concentration, in

[1] USDA, *Assessment of the Cattle and Hog Industries, 2000.*
[2] WORC estimate based on analysis of USDA figures by Oregon State University Prof. Catherine Durham.

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combination with increasing vertical integration in the form of packer ownership of cattle and forward contracting, threatened the continued openness and competitiveness of cattle markets.

For the next several years, we worked to bring this problem to the attention of the Justice Department, USDA, and our members of Congress. In the spring of 1994, fed cattle prices dropped precipitously. Anecdotal evidence and market reports suggested that the use of captive supplies by packers increased dramatically at the same time. In response, WORC organized meetings in auction yards and town halls across the Great Plains. Out of those meetings, WORC developed a moderate, common sense proposal to deal with the problem of captive supplies, without banning forward contracts outright.

In 1996, WORC submitted this proposal as a Petition for Rulemaking on Captive Supply Procurement Practices to the Department of Agriculture, seeking adoption of rules under Section 202 of the Packers and Stockyards Act. USDA has never acted on the petition's recommendations. The straightforward rules proposed in the petition would serve as a remedy for two kinds of anticompetitive practices:

- The potential for price discrimination and undue preferences in violation of Section 202, subsections (a) and (b) of the Packers and Stockyards Act; and
- The potential for intentional or effective price manipulation in violation of Section 202, subsection (e).

The petition asked USDA to adopt rules to require forward contracts for procuring cattle for slaughter to contain a firm base price that can be equated to a fixed dollar amount on the day the contract is signed, and to require forward contracts, and cattle owned or fed by packers, to be offered for sale in an open, public market.

More than 1,600 cattle producers and consumers, responding to a Federal Register notice seeking comments, supported WORC's proposal; they outnumbered opponents by 33 to 1. Organizations supporting the proposal represent hundreds of thousands of producers and consumers. The minority report of Secretary Glickman's Advisory Committee on Agricultural Concentration supported the proposal, as did the Secretary's National Commission on Small Farms.

Years of meetings, studies, and accumulated evidence, culminated in a forum on captive supplies sponsored by USDA's Grain Inspection, Packers and Stockyards Administration in Denver in September of 2000. But USDA has taken no steps to update its regulations to deal with changing marketing practices and tools developed by packers and feeders, a need Congress anticipated and provided for when it enacted the Packers and Stockyards Act in 1921. USDA has taken no action at all to effectively address the discriminatory and manipulative effect of captive supplies, despite the clear language of Section 202 of the Packers and Stockyards Act.

Of course, the problem has not gone away. The percentage of cattle acquired by packers through contracts without negotiated prices and through outright packer ownership has continued to increase.[3] A survey of feedlots in Iowa, Kansas, Nebraska and Texas found that 23 percent of

[3] USDA's Packers and Stockyards Administration and Agricultural Marketing Service do not agree on how to define or measure captive supplies, but it is indisputable that captive supplies have increased.

respondents cattle were sold under marketing agreements in 1996, 52 percent were sold under such agreements in 2001, and respondents expected 65 percent to be sold through marketing agreements in 2006.[45] Control of this much supply and the date on which they will be slaughtered, confers the power to manipulate cash market prices on packers. Through strategic use of those captive supplies, packers can drive down the cash market – which, in turn, becomes the base price for most of those captive supply contracts.

In effect, these formula agreements, in which control is transferred to the packer before a price is negotiated, amounts to packer ownership of cattle, except the packer doesn't have to go through all the bother of feeding them or paying interest on a bank loan. There is no justification for these kinds of agreements. They do nothing to reward producers for quality; most of the cattle delivered under these contracts bring 50 cents or a dollar per hundredweight over some future cash market price, whatever their quality. Moreover, payment of premiums and discounts for quality can be accomplished through contracts that have a negotiated, fixed-base price.

Neither do these contracts lower risk for the producers who enter into them. Of course, they are assured of getting just above the average market price, or even the "top of the week", but they increase the chance that the average market price will be lower than a competitive price. If insufficient competition is costing you $5 per hundredweight, it is of small consolation that you're getting 50 cents more than the prodcuer who had to sell in the cash market.

After nearly ten years of increasing strategic use of captive supplies by packers – ten years of increasingly dysfunctional markets – it should be no surprise to anyone that the packers' share of the consumer's retail beef dollar has increased at the expense of the farmers and ranchers who raise cattle. The farm share of the consumer dollar was 60% twelve years ago. It fell to just 42% in some months in 2002. Despite record retail beef prices, producers are still getting less than 50% of the consumer dollar most months. Put another way, the producer's gross share of the money consumers spend on cuts of choice beef at retail has declined 30%. USDA has failed to address the market imbalances and dysfunctions that allow packers and retailers to capture such large, increasing, and unwarranted shares of the consumer beef dollar.

The Packers and Stockyards Act says that it is unlawful for a packer to "engage in or use any unfair, unjustly discriminatory, or deceptive practice or device." Packers unfairly and unjustly discriminate against some producers by offering and agreeing to forward contracts and marketing agreements only with select producers, and in failing to offer them openly and publicly. Packers'

[4] Schroeder, Lawrence, Ward and Feuz, *Fed Cattle Marketing Trends and Concerns: Cattle Feeder Survey Results*, p. 1. On Friday of last week, USDA's Agricultural Marketing Service reports indicate that approximately 60% of the cattle committed to U.S. plants for slaughter were acquired through contracts with a negotiated price. Thirty-three percent were acquired under a formula agreement, with no base price negotiated; another seven percent were acquired through forward contracts based on futures prices. Ninety-five percent of these cattle were committed under agreements giving the packer control over the date of delivery. The percentage of cattle acquired through formula agreements is much lower than before the Canadian border was closed to live cattle in May, indicating that packers are having to purchase cattle on the open market because of the shortage of fed cattle in U.S. feedlots. USDA Market News, NATIONAL DAILY DIRECT SLAUGHTER CATTLE - COMMITTED and DELIVERED CATTLE - Summary for October 31, 2003; http://www.ams.usda.gov/mnreports/lm_ct106.txt.

use of such contracts with prices based on thin cash markets, which they can and do influence, is an unfair and deceptive practice or device, but USDA has not enforced the law.

The Act says a packer may not give "undue or unreasonable preference or advantage to any particular person or locality in any respect whatsoever, or subject any particular person or locality to any undue or unreasonable prejudice or disadvantage in any respect whatsoever." Current marketing agreements and forward contracts often give preference to some cattle feeders over others with access to markets and timely slaughter. Packer-ownership of cattle supplies gives undue preference to the stockholders of packing companies with access to markets and timely slaughter. These practices violate the Act, but USDA has not enforced the law.

The Act says packers may not "engage in any course of business or do any act for the purpose or with the effect of manipulating or controlling prices, or of creating a monopoly." The packers' strategic use of captive supplies, and the use of forward contracts and marketing agreements without a fixed base price, has had the effect of manipulating or controlling prices, in violation of the Act.[6] But USDA has not enforced the law.

In the face of these failures by USDA, WORC asks this Committee to reinvigorate the Packers and Stockyards Act by adopting amendments to the Act. Since USDA will not use the tools Congress gave it in 1921, Congress must act to give USDA new tools, and then closely monitor how it uses them.

We urge this Committee, the Senate and the Congress to end the price-manipulating abuses caused by what Iowa State economist Neil Harl calls the "deadly combination" of high market concentration and vertical integration in our cattle markets. We urge adoption of Senator Johnson's legislation to ban packer ownership of livestock, and Senator Enzi's bill, S. 2021, to take the "captive" out of captive supplies.

Banning packer ownership is a critical reform, which WORC strongly supports, but it deals with only one part of the problem. It does not address the secret, Enron-style forward contracts and marketing agreements through which most hogs and nearly half of all cattle are transferred from producers to packers[7]. Senator Mike Enzi (R-Wyoming) introduced S. 1044, the Captive Supply Reform Act, to address these other kinds of captive supplies – *without* prohibiting their use.

S. 1044 would make two reforms to restore open, fair competition to the market for livestock contracts. S. 1044, the Captive Supply Reform Act, would:

- Require a fixed base price in formula contracts.
- Require that contracts be traded in open, public markets – no more secret deals.

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[6] This was demonstrated by USDA's own Red Meat Concentration study, which shows that formula base-priced marketing agreements are associated with much lower cash market prices than are fixed base priced forward contracts.

[7] Per January 2000 study by University of Missouri/National Pork Producers Council, cited in GIPSA report, *Assessment of the Cattle and Hog Industries, Calendar Year 2000,* p. 26)

Most marketing agreements for cattle and hogs do not contain a negotiated price. Instead, the price is based on a reference price that the packer can influence – such as the price it will pay for non-contract livestock out of one of its plants next week. The Captive Supply Reform Act would end this price-manipulating practice by requiring contracts and agreements to have a fixed base price. It *would allow* contracts to be based on futures market prices, and it would not affect any premiums, discounts, or other adjustments now used in many forward contracts and marketing agreements.

S. 1044 would restore competition by making packers (and livestock producers) bid against each other to win a contract. Forward contracts and marketing agreements allow packers and producers to coordinate supply and reduce risk, but as they are currently negotiated – in secret, with all of the bargaining power on one side – they unjustly depress prices and reduce market access for small and independent producers. S. 1044 would require such contracts to be traded in open, public markets (such as an electronic market) to which all buyers and sellers could have access. The bill preserves the benefits of forward contracts and marketing agreements, while eliminating characteristics of current contracts that lead to price manipulation and price discrimination.

The Committee and the Congress should be aware that these reforms – the Captive Supply Reform Act, and the ban on packer ownership – are what cattle producers want.

* A survey of cattle feeders by the *High Plains Journal* for the Kansas Cattlemen's Association found that, 90% believe that consolidations and mergers have eliminated competition, and 92% believe that packers should not be able to own or feed cattle.

* Cattle feeders surveyed by Schroeder, Lawrence, Ward and Feuz agreed that

- Cash market bids by packers are lower when packers have cattle contracted;
- Base prices in marketing agreements should be negotiated, rather than based on future cash price reports or plant averages;
- Packers should not be permitted to own and feed cattle.[8]

Respondents were split, but slightly disagreed with the statement that "packers should not be allowed to contract or form marketing agreements with feeders and cattle owners."

The Captive Supply Reform Act and legislation banning packer ownership respond to these expressed preferences by cattle feeders – to end packer ownership, and to reform but not prohibit contracts and marketing agreements.

We urge the United States Senate and the Congress to adopt Senator Enzi's Captive Supply Reform Act and Senator Johnson's proposed ban on packer ownership of cattle. We encourage this Committee and the Senate Agriculture Committee to use your investigative powers to collect the evidence that USDA has been unable or unwilling to collect from packers, and to exercise stringent oversight of USDA's enforcement of the Packers and Stockyards Act.

[8] Schroeder, Lawrence, Ward and Feuz, *Fed Cattle Marketing Trends and Concerns: Cattle Feeder Survey Results*, p. 8.

News From:

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Statement of U.S. Senator Russ Feingold
At the Senate Judiciary Committee Hearing on "Monopsony Issues in Agriculture: Buying Power of Processors in Our Nation's Agricultural Markets"

October 30, 2003

I want to thank you, Mr. Chairman, for holding this hearing to shed light on an important issue for farmers and their families. I appreciate the opportunity to share my views on the power of buyers in agricultural markets. Increased consolidation and market concentration are, without question, of very significant concern for producers throughout the nation. As I travel around my home state of Wisconsin, these issues are raised constantly by farmers and growers.

Monopsony power is a serious concern because this power can so easily be abused. When there is only one buyer of a commodity, farmers fear that the price that they receive and the terms of the transaction will be unfairly biased against them. Farmers are rightfully troubled by inadequate market access, price discrimination against the small, independent producer, and loss of negotiating power for the men and women producing the product.

I am pleased to be an original cosponsor of the Fair Contract for Growers Act of 2003, which addresses one unfair result of monopsony power in this industry. It is designed to provide greater fairness in the arbitration process relating to livestock and poultry contracts. I believe that arbitration can be an effective and appropriate method to resolve disputes between farmers and those who purchase their products, but only when both parties voluntarily participate. Many farmers, however, due to their disadvantaged economic position, are forced to sign contracts presented to them by large processing firms that include mandatory arbitration clauses. There is no negotiation between the farmer and processor in these instances – farmers must accept the contract as written, waiving their constitutional right to have their disputes under the contract decided by a trial by jury.

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I would like submit a letter for the record from numerous farm and consumer organizations, as well as advocates for animal protection and rural communities, expressing their support for the Fair Contracts for Growers Act.

The Senate and this Committee have both demonstrated strong, bipartisan support for rectifying the injustices of mandatory arbitration. During the debate on the farm bill in the last Congress, I offered an amendment with a senior member of this Committee from Iowa, Senator Grassley, to prohibit the use of mandatory arbitration clauses in livestock and poultry contracts. Our amendment passed the Senate by a vote of 63 to 31, but it was dropped in conference. This Committee has supported similar arbitration measures in the past, such as the "auto dealer" arbitration bill that the Chairman worked to enact in the 107th Congress.

The Fair Contract for Growers Act addresses only one piece of the complex business relationships in agricultural markets that are becoming increasingly concentrated. The growing concentration of agricultural buyers raises serious questions about the Department of Justice's enforcement of existing laws as well as the adequacy of those laws to ensure a fair, open, and equitable market.

# # #

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Opening Statement by Senator Chuck Grassley
Senate Judiciary Committee Hearing
"Monopsony Issues in Agriculture: Buying Power of Processors in Our Nation"
Thursday, October 30, 2003

Thank you Mr. Chairman for providing us this important opportunity to discuss the negative impacts monopsonistic control can have on family farmers and rural America.

Monopsony is to buying as monopoly is to selling. When family farmers have limited options to market their commodities, they face potential monopsonistic conditions. For decades the government has agressively protected America's consumers through the Sherman and Clayton Acts from monopolistic activities. Unfortunately, the concept of monopsonies has not seemingly drawn as much attention.

Today I hope that we take this opportunity to focus on how DOJ attempts to identify monopsonistic practices. While I believe Justice attempts in good faith to remedy monopsonies when it finds a problem, I worry the calf isn't finding the creep when it comes to this issue.

I'm concerned DOJ doesn't have the agriculture specialists on board who understand the unique marketing dynamics farmer's experience and their relationship with industry. DOJ can't remedy the problem unless it understands the potential harm.

To the Department of Justice's credit, it has challenged or limited agri-business mergers in the past due to monopsonistic concerns. I know that Assistant Attorney General Pate has laid out many examples in his testimony of DOJ's interest in keeping markets competitive. One example of DOJ's commitment that Mr. Pate did not describe is the case United States vs. Rice Growers Association. Justice tried this case in 1986 and challenged the purchase of one rice milling firm buying another milling firm. DOJ found that within the regional market the new entity would control 60% of the rice purchased and that was unacceptable to DOJ.

Clearly DOJ has the authority to act, I'm just not certain this DOJ or any Justice Department in recent history has hired professionals with the expertise and background to identify the actual markets being affected.

For instance, 87% of all hogs are contract or packer-owned pigs. That means only 13% have the potential to be open or "spot market" pigs. Over 90% of hog marketing contracts are

based on a composite "spot market" price to establish the base value.

Many hogs not bound to written contracts are sold under oral formulas. The value of these types of oral agreements do not necessarily track with spot market value. In addition, hogs sold outside of the western corn belt don't contribute substantively to mandatory price reporting data.

I've seen estimates that of the 13% of hogs deemed "open market" pigs, only 3-5% traded daily are actually legitimate spot market pigs. That 3-5% sets the price daily for 90% of pigs packers have under marketing contracts.

It should be easy to understand that as the actual spot market thins out, if packers choose not to participate in the spot market every day, packers potentially will be able to manipulate the spot market price and influence the worth of marketing contracts. I feel strongly we need to be on the look-out for this type of market manipulation.

Unfortunately, the potential for this type of manipulation grew considerably when Smithfield, the world's largest vertical integrator acquired Farmland.

DOJ staff informed my office that the Justice Department did not believe this transaction met any threshold to justify challenging the acquisition. Justice explained that there would still be multiple purchasers in the western corn belt after this merger took place.

I've tried to take a look at the packers participating in the Southern Minnesota, Iowa, South Dakota, and Nebraska region. Unless DOJ believes that a family farmer which produces 2000 hogs per year, selling 40 per week, using a trailer pulled by a pickup can reasonably be expected to deliver hogs up to 300 miles away from his farm, I think we have a problem.

On a related topic, I would be remiss if I did not take this opportunity to voice my concern not only for the spot market's impact on contracts, but for the construction of producer contracts. As the lead sponsor of the Fair Contracts for Growers Act (S. 91) I am very concerning about the abuse of arbitration clauses in "take-it-or-leave-it," non-negotiable contracts, such as those that are typical in the livestock and poultry sectors.

Certainly arbitration, if agreed to voluntarily by both parties involved, can be a useful tool for resolving disputes. But what we are now seeing in the livestock and poultry sectors is that arbitration clauses are being forced on farmers not as a legitimate alternative dispute mechanism, but as a mechanism to prevent farmers from challenging the abusive actions of large packers or integrators.

Farmers who are forced into arbitration proceedings are rarely, if ever, successful. In large part, this is because the process is stacked against them because arbitration does not allow for the right of discovery. If a farmer is attempting to prove that he has been treated unfairly or has been the victim of fraud, all the data that would allow him to argue his case is completely controlled by the company being accused of misdeeds. Without access to that data through the normal discovery process, it is impossible for a farmer or grower to prove his case.

And lastly, arbitration proceedings are not part of the public record. By forcing growers to sign away their rights to resolve disputes in court, livestock and poultry companies are able to limit public knowledge about any abusive practices they may use in their dealings with farmers.

So it's easy to understand why a large, vertically integrated livestock or poultry company might see the benefits of including a mandatory arbitration clause in their contracts with farmers. And unfortunately, we also understand that farmers are often put in a position where they either have to sign the contract presented to them, or face bankruptcy. But what I do not understand is why we allow this to happen.

The chairman of this committee was the lead sponsor of a bill in the last Congress which addressed concerns about the abuse of mandatory arbitration clauses in contracts between auto manufacturers and car dealerships. That legislation, which is nearly identical in structure to the bill that Senator Feingold and I have introduced, is now law.

Our legislation would simply specify that both parties in a livestock or poultry contract must agree in writing to pursue arbitration, AFTER THE DISPUTE ARISES, to assure that farmers chose arbitration voluntarily.

It is my hope that we will be comfortable affording farmers the same protections against abusive contract terms that we have provided for the car dealers of this country.

In conclusion, I want to thank the chairman for holding this hearing and I look forward to working with both the committee and DOJ to further explore this issue. I would also like to submit for the record the testimony of Dr. Neil Harl from Iowa State University who we invited to testify today but had a conflict.

U.S. Senator
TOM HARKIN OF IOWA

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FOR IMMEDIATE RELEASE
October 30, 2003

Contact: Allison Dobson/Matt Hartwig

Testimony before the Senate Committee on the Judiciary
"Monopsony Issues in Agriculture: Buying Power of Processors in Our Nation's Agricultural Markets."

"Thank you for this opportunity to appear today to address a crucial issue facing Rural America: Consolidation and vertical integration in the processing and retail sectors of our food industry. I commend this Committee for focusing on a very important, but sometimes forgotten, goal of Antitrust policy; that is to protect small firms, like independent farmers, that sell their goods into consolidated, anticompetitive markets.

"As Ranking Member of the Agriculture Committee, I am all too familiar with the numbers: 80% of steer and heifer slaughter is controlled by four firms; soon, 64% of hog slaughter will be controlled by four firms. Just as these industries have become more horizontally consolidated, they have also increased the use of vertical arrangements. Apparently modeling itself on the poultry industry, hog packers now have 80% to 90% of their supply tied up in some type of vertical arrangement. And these are only a few examples of the increased consolidation and vertical integration in agriculture.

"The essential problem with consolidation and vertical integration, when taken too far, is that such trends reduce choice and efficiency in the marketplace. These trends eliminate a farmer's options because either there simply are not as many buyers in a region, or the buyers already own or control their supply so independent producers do not have access to that market. The lack of choice can lead to unequal bargaining power in business relationships. With unequal market power, the more dominant firm will almost always take advantage of the more vulnerable party by squeezing price, shifting liabilities, or demanding certain terms without paying an associated price.

"Congress enacted the Sherman and Clayton Acts not only to protect consumers from sellers who have too much power, but also to protect sellers from buyers who have too much power. The Department of Justice is charged with enforcing these laws. I fear, however, that the DoJ has shirked its responsibilities when it comes to protecting independent farmers.

"The most disturbing recent development involves Smithfield's acquisition of the Farmland Foods pork division. This acquisition is just an example of the spiraling consolidation and vertical integration that threatens independent agriculture. I wrote to Attorney General

Ashcroft several times as Smithfield, the world's largest pork producer and processor, was in the process of acquiring Farmland. But the Department seemed to ignore the concerns of independent producers and let the deal go through untouched. Smithfield's acquisition of Farmland will strengthen its leverage over family pork producers and represents even more concentration and vertical integration in an already rapidly consolidated pork processing industry.

"Smithfield's version of hog production, in which it owns all of the hogs and reaps all of the entrepreneurial profit, does not bode well for the future of the rural Midwest. Smithfield has a history of shutting down plants that it buys. Yet even if the plants remain open, the market would still lose a buyer and become more concentrated.

"This acquisition will also harm consumers because it provides pork processors with greater market power. With one firm able to control such a great amount of market share, consumers face the increased possibility of inflated prices in grocery stores. Despite Smithfield's past actions and the potential degree of control they would hold over the sector, DoJ allowed the acquisition to go through.

"As Ranking Member of the Agriculture Committee, I realize that the job of addressing competition problems in agriculture does not lie solely with the Judiciary Committee. The Agriculture Committee has jurisdiction over the Packers and Stockyards Act, the Agricultural Fair Practices Act, and the Perishable Agricultural Commodities Act. All of these laws are designed to protect producers from unfair trade practices or help producers gain bargaining power through cooperatives. I have fought for reform in all of these laws by sponsoring or cosponsoring such measures as a ban on packer ownership and strengthening of the Agricultural Fair Practices Act. In fact, one reason I wanted to testify today was to invite more cooperation between our committees in protecting farmers against unfair and anticompetitive conduct.

"In conclusion, I would like to thank you once again for convening this important hearing. Rural America depends on a vibrant agricultural sector. And this nation's farmers depend on competitive markets for their economic well-being. I commend you for exercising oversight in this crucial area and look forward to working with you in the future to improve the competitive environment for producers and consumers across this country."

Testimony Presented
to
Committee on the Judiciary
United States Senate

October 30, 2003

The Structural Transformation in Agriculture: Vulnerability of Producers in an Environment of Concentrated Purchasers of Commodities

Mr. Chairman, members of the Committee on the Judiciary, I appreciate the opportunity to submit testimony on this important policy issue and commend you for focusing attention on the matter.

Agriculture in the United States faces four major problems in the new century—(1) formulation and reformulation of price and income policy, including meaningful limitations on farm program payments; (2) the structural transformation of the agricultural sector; (3) consumer acceptance of genetically modified foods; and (4) bioterrorism. All four problem areas are discussed in papers posted at www.econ.iastate.edu/faculty/harl. The discussion following focuses only on the more pressing aspects of the structural transformation issue.

As with most sectors of the world economy, agriculture in recent years has been a sector of great change. Closed markets are giving way to free trade (albeit with some speed bumps encountered along the way), open democratic systems with decentralized decision making are gaining ascendancy over despotic regimes, technology is revolutionizing every facet of production and distribution and competition is assuring that consumers everywhere are elevated to a high pedestal faintly reminiscent of the kings of old.

It is assumed that the governing policy goals for the food and agriculture sector will continue to include—(1) availability of an abundant supply of food, at reasonable prices; (2) maintenance or enhancement of the productivity and environmental integrity of natural resources; and (3) a prosperous and productive economic climate for producers (including family farmers). It is this last goal that I would like to address today.

Structure of the agricultural sector

With the dramatic increases in concentration in recent years of input supply and output processing firms and with striking increases in the level of vertical integration, it is important to assess the implications for producers. Such a structural transformation of a subsector is not unknown—the broiler industry went that direction several decades ago—but vertical integration of hog production is a first for the Middle West.

The critical question: is it important to farmers—and to society—whether agriculture is populated by independent entrepreneurs or serfs? The structural change now occurring will determine which direction agriculture takes. A producer without meaningful competitive options is a relatively powerless pawn in the production process.

The evidence is overwhelming that the agricultural sector is undergoing the greatest structural transformation in the history of the sector. *Without much doubt, low commodity prices have contributed to the structural transformation of the sector.* A low risk, low return choice looks attractive if the alternative is bankruptcy.

Competition is the most critical element of a price oriented, market economy. Without competition, firms become complacent, are less likely to innovate, tend to become arrogant and indifferent and are inclined to produce less and obtain a higher price for their output.

To a considerable extent, structure will be driven by economic considerations. This country has been committed for some time to the notion that if someone can develop ways to produce goods or services at a lower cost, barriers are unlikely to be erected to prevent that from happening. In large part, the consumer is king and generally rewards the best value with purchases. However, for the economic system to function properly, it is critical to have—

- Policies in place to deal with cost externalities such as odors and stream and groundwater pollution, and

- A system of market protection (or antitrust) to penalize collusion and to prevent undue concentrations of economic power.

The era of contract agriculture. The signs of increasing use of contracts are commonplace—especially on the production side of agriculture.[1] Specialty grains, feeder livestock, milk production, even fruits and vegetables, are being produced under contract and have for some time. So what's the concern about the rising tide of contract agriculture? Basically, the concern is a tilt in market power with a possible shift in bargaining power as input suppliers and output processors (and first purchasers otherwise) gain greater economic power, undoubtedly at the expense of producers.[2]

Concentration in input supply and output processing companies. Mergers, alliances, and various other types of arrangements are reducing the number of players in input supply and output processing and handling and increasing the level of concentration. While the level of mergers, alliances and consolidations is not a completely reliable indicator of competition, the fact that nearly $15 billion of such amalgamations has occurred over the past eight years in the seed business, some at price levels difficult to justify under present economic conditions, suggests that—(1) some are discounting revenue from a pot at the end of some unknown

[1] See, e.g., Harl and Lawrence, "Long-term Marketing Contracts with Packers...A Journey Through the Downside," Iowa Pork Producer, Sept., 1998, pp. 5-7.

[2] See generally Harl, "Contract Agriculture: Will It Tip the Balance?" 10 Leopold Letter No. 4 (1998); Harl, "Agriculture in the Twenty-First Century," http://www.econ.iastate.edu/faculty/harl/ (papers of interest).

rainbow; (2) irrational behavior is being displayed; or (3) some acquiring firms are assuming that a greater share of the world's food bill can be claimed by those who control the germ plasm involved in food production.

Increasing levels of concentration among firms do not tell the entire story. The revolution in ownership of germ plasm, the feature of cells that determines the characteristics of offspring, is moving rapidly toward concentration in a few hands. The high-profile alliance (and now merger) between DuPont and Pioneer Hi-Bred International, the Monsanto acquisition of DeKalb, the Monsanto acquisition of Delta and Pine Land Company (since terminated), the formation of Syngenta by Novartis and AstraZeneca and the proposed acquisition of the Farmland Industries red meat division by Smithfield Foods are recent examples of how the ownership and control of input supply and processing are falling into the hands of a few, economically powerful players.

The "deadly combination." Without much doubt, the greatest economic threat to farmers as independent entrepreneurs is the deadly combination of concentration and vertical integration. Producers are vulnerable to a combination of high levels of concentration in input supply and output processing and high levels of vertical integration from the top down.

As is well known, in addition to pressure on suppliers, monopoly generally leads to prices higher than competitive levels plus the use of technologies that are less efficient than could have been used.[3]

As a group of Purdue agricultural economists has stated, "We see evidence of increased concentration to the point where public vigilance is warranted. Concentration indices are high and may be reaching the point where markdown pricing on hogs will be significant and place producers at a clear disadvantage.... Two major policy options are anti-trust activity on the one hand and increasing the market power of hog producers on the other."[4]

In short, whoever controls the limiting factor or controls the "hold-up" points in any process is in a position to exert influence over the entire process and, if the level of concentration is high, exact a hefty charge against the fruits of production. In hogs the limiting factor is not capital or labor or buildings; the limiting factor is slaughter capacity or "shacklespace." In food generally, an important limiting factor is shelf space.

Vertical integration. The moves made by the major players, both input suppliers and output processors and handlers, could lead one to conclude that the objective is to vertically integrate the sector. Such an objective could be pursued for several reasons—(1) to gain and maintain greater control over patented products or products subject to intellectual property protection otherwise; (2) to apply economic pressure on producers to relinquish functions in favor of the integrator (such as risk management) or to merely provide an opportunity for risk to

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[3] See, e.g., Holmes and Schmitz, "Competition at Work: Railroads vs. Monopoly in the U.S. Shipping Industry," Quarterly Review, Federal Reserve Bank of Minneapolis, Vol. 25, No. 2, Spring, 2001, pp. 3-27.
[4] Paarlberg, Boehlje, Foster, Doering and Tyner, "Structural Change and Market Performance in Agriculture: Critical Issues and Concerns About Concentration in the Pork Industry," Staff Paper #99-14, Purdue University, October 1999, submitted as testimony to the U.S. House of Representatives, Committee on the Judiciary, October 20, 1999.

be off loaded onto the integrator; (3) to reduce costs (particularly acquisition costs for raw materials) of the integrating firm; (4) to achieve greater market share on an assured basis; or (5) to deliver with greater precision what consumers want. The latter point is debatable. In an early example, seed/chemical companies misjudged consumer acceptance of genetically engineered foods and stumbled badly in the process.

Although vertically integrating a sector or subsector may produce economies—including reduced costs for acquisition of raw materials—vertical integration by powerful integrators can have decidedly negative consequences. Among those negative outcomes is the demolition of open, transparent, competitive markets and replacement of those markets with negotiated prices. With a huge difference in bargaining power, as between the parties, the outcome is predictable. The party with the weaker market power tends to be the loser. Unless producers act collectively, producers tend to be the weaker party.

Example: let's assume concentration in hog slaughter continues to increase (the four largest firms would control nearly 65 percent of hog slaughter compared to more than 80 percent for steer and heifer slaughter, as show in Table 1.) and the hog slaughtering firms vertically integrate in the manner pioneered by Smithfield. Let's say we're down to two huge firms and each is 90 percent integrated. A producer with a five-year contract with one of the two major firms comes to the end of the contract. The new contract is considerably less attractive than the expiring contract. The producer is told—take it or leave it. If the closest competitive option is 900 miles away—and is also heavily integrated—the producer seeking another option for hogs is highly vulnerable. If the producer had made a heavy commitment to facilities, the vulnerability is greater yet with significant barriers to exit. Clearly, a producer in that situation is likely to be squeezed.

Agriculture is demonstrably different from other sectors that have been transformed through concentration among purchasers and vertical integration. If an automobile manufacturer squeezes a supplier, the manufacturer typically has only a few choices, if any, as to alternative suppliers that can respond in a timely fashion. In agriculture, the large number of potential

Table 1. Four firm packer concentration ratios (in percent)

Year	Cattle	Steer & Heifers	Cows/Bulls	Hogs
1980	28	36	10	34
1985	39	50	17	32
1990	42	55	18	33
1995	69	81	28	46
1996	66	79	29	55
1997	68	80	31	54
1998	70	81	33	56
1999	70	81	32	56
2000	69	82	32	56

Source: International Agricultural Trade and Development Center, University of Florida.

suppliers means that a packer or meat processor that applies economic pressure on a producer has an almost infinite number of alternative growers. Moreover, in the face of a regionally dominant meat packer or processor, the cost of shipping livestock to another purchaser is generally high and assures the regionally dominant packer a substantial price margin before it is economically feasible for a producer to ship the animals to another packer or processor.

Are economies from vertical integration likely to be passed on to consumers? With a high level of concentration, that's doubtful. Actually, several possible outcomes could be occurring in the merger/vertical integration movement.

- If the structural transformation now being observed reflects efficiencies, lower costs could be passed to consumers *if competition is present and the competitive system is functioning well.*

- In the event gains from efficiency are not passed to consumers, but are passed to shareholders or used to pad costs within the firm, the trend is objectionable even though some would argue that system-wide gains in efficiency should be permitted even in the face of anti-competitive conditions.

- The third scenario, which is concerned with the distributional effects of competition policy, does not recognize gains from efficiency as a positive offset to an otherwise anti-competitive merger unless the gains are passed on to consumers.

Clearly, the higher the level of concentration and vertical integration, the greater the risk of unacceptable market conduct.

What all of this adds up to is this—*if farming is to be made up of independent entrepreneurs as producers, it is absolutely essential for producers to be assured of meaningful competitive options.* To assure that outcome, it is necessary to—(1) limit concentration in input supply and output processing or handling and (2) limit the extent of vertical integration.

Reform of contract practices. The great disparity in market power tends to lead to contracts with oppressive features (as viewed by the weaker party), retaliatory practices by the stronger party and vulnerability of the weaker party in terms of securing payment. The Producer Protection Act, which has been proposed and endorsed by 17 State Attorneys General, would take several steps as a matter of state law towards providing full information to the producer and lien protection to the producer to secure payment of amounts due and reducing the probabilities of economic retaliation in producer-processor contract relationships.

The proposed legislation contains six parts—

- Require contracts to be stated in plain language and disclose material risks;
- Provide contract producers with a right to review and a three-day cancellation period;
- Prohibit confidentiality clauses;
- Provide producers with a first priority lien for payments due under the contract;
- Prevent capricious or retaliatory termination of the contract; and
- Prevent retaliation against producers who participate in producer organizations.

Although the proposal has been criticized,[5] the provisions all have precedent in other areas of the law, such as consumer protection legislation and trade regulation, and all are based on basic principles of fairness, full information and equity which are common throughout the law.[6]

The Family Farmer Cooperative Marketing Amendments Act of 2001, which was introduced in the U.S. House of Representatives, would have addressed some of the same issues at the federal level.[7]

The 2002 farm bill (The Farm Security and Rural Investment Act of 2002)[8] contains a section dealing with confidentially provisions in contracts for the production of livestock or poultry or in any marketing agreement with a term of one year or more.[9] The 2002 Act also includes "swine contractors" as a covered entity under the Packers and Stockyards Act of 1921.[10]

Assessment of the problem by the regulatory agencies

I am mindful that mergers, acquisitions and amalgamations, as well as anti-competitive practices in purchasing, have generally been evaluated on the basis of expected or likely impact on consumers. Unfair or anti-competitive practices in purchasing may not have an immediate impact on consumers. However, in the long run, such practices, if left unchecked, lead to failure of the concentrated buyers and processors to pass along the gains from efficiency to consumers with the gains either used to fatten the bottom line or to fund wasteful or unnecessary expenditures on the part of the livestock purchasers and processors. Moreover, with less of the fruits of production left with the producer, which is the usual outcome where monopsony and vertical integration exist, the rural community is a major loser as well as the producer. Indeed, what is at stake here in the long run is the economic health of rural America.

As with mergers and concentration in other sectors, as noted, the approach generally taken in evaluating mergers (and concentration) among purchasers of a commodity has been to examine the problem from the perspective of the consumer. For hog slaughter, for example, with a national market posited for pork, further concentration is viewed in less worrisome terms than if the problem is assessed from the standpoint of the producer. With a regionally dominant packer, the vulnerability of producers becomes clear as noted earlier. Thus, if the objective is to encourage a sector of independent entrepreneurs, rather than a sector of serfs, it is critically important from a policy perspective for the anti-competitive consequences of further mergers, alliances, amalgamations or other arrangements to be assessed on the basis of impact on producers as well as on consumers. Indeed, if the objective is to encourage a sector of independent entrepreneurs, the emphasis must be on working to assure meaningful competition options for commodities produced.

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[5] See Boehlje, Schrader, Hurt, Foster and Pritchett, "The Producer Protection Act—Will It Protect Producers?" 18 *Agric. Law Update* No. 2, pp. 4-6 (2001).
[6] See Harl, Stumo, McEowen, Heffernan and O'Brien, "The Producer Protection Act—Will It Protect Producers? A Rejoinder," 18 *Agric. Law Update* No. 3, pp. 1-7 (2001).
[7] H.R. 230, 107th Cong., 1st Sess. (2001).
[8] Pub. L. No. 107-171, 107th Cong., 2d Sess. (2002).
[9] *Id.*, Act § 10503.
[10] *Id.*, Act § 10502, amending Sec. 2(a) of the Packers and Stockyards Act of 1921, 7 U.S.C. § 182(a).

If the current trends continue (in terms of ever-higher levels of concentration and vertical integration from the top down), it will be the death knell for family farm agriculture in this country and will be a serious blow to the economic vibrancy of rural communities.

An important issue is whether oversight should remain with the Department of Justice, Antitrust Division, and the Federal Trade Commission, or whether a ramped up, energized oversight regimen should be the province of the Department of Agriculture. My belief is that the interests of the country are best served in terms of both consumers and producers, with a program of enhanced competition by lodging jurisdiction with the Department of Justice with additional resources provided for work in the agricultural sector. Certainly additional funding is needed to achieve a level of oversight that will result in meaningful competitive options for producers of farm products.

I have watched at close range for more than 40 years the efforts of the U.S. Department of Agriculture (particularly in reference to the administration of the Packers and Stockyards Act). 42 Stat. 159 (1921). Chapter 71 of volume 10 in my 15-volume treatise, *Agricultural Law* (Matthew Bender & Co.) devotes 192 pages to the Act. The record is one of disappointment. USDA, from the time of enactment of the Packers and Stockyards Act, in 1921, has failed to use its authority to protect livestock producers. This failure to act has become more serious in recent years as the structure of the livestock industry has been transformed and procurement practices have been changed in response to further consolidation in meat packing and processing and vertical integration by packers and processors. The General Accounting Office in its report, *Packers and Stockyards Program—Actions Needed to Improve Investigations of Competitive Practices*, stated forthrightly that USDA has extensive authority under the Packers and Stockyards Act to bring actions regarding unfair and anti-competitive practices and has rarely done so.

USDA has had more than 80 years to adopt regulations that would address, in a meaningful fashion, the anti-competitive acts and practices in livestock procurement. The department has failed to measure up to the expectations evident in the legislation and the legislative history.

While the Department of Justice has yet to display a commitment to assuring free, open, competitive and transparent markets for livestock, it is my belief that the additional resources needed to achieve such a result would be best placed with the Department of Justice with a clear signal from Congress that unfair and anti-competitive practices in agriculture are not in keeping with the national commitment to competition since enactment of the Sherman Act in 1890.

If the decision is made to ramp up oversight through the U.S. Department of Agriculture, Congress should—(1) provide clear marching orders to USDA and (2) appropriate adequate funds for the task.

Conclusion

More than a century ago, the United States rejected the idea of unfettered economic activity by firms in highly concentrated industries. The wisdom of that conclusion has never been more

clear and the need for aggressive implementation of that philosophy has never been more obvious than now.

To assure competition, the lifeblood of our economic system, it is vital that steps be taken now to increase competition in all areas where high levels of concentration exist and particularly in areas where high levels of concentration exist in tandem with efforts to integrate vertically the production and processing functions from the top down. The trend toward demolishing free, open, transparent and competitive markets as the even-handed referee in those markets must be halted if farmers and ranchers are to exist as independent entrepreneurs rather than as serfs.

News Release
JUDICIARY COMMITTEE
United States Senate • Senator Orrin Hatch, Chairman

October 30, 2003 Contact: Margarita Tapia, 202/224-5225

Statement of Chairman Orrin G. Hatch
Before the United States Senate Committee on the Judiciary
Hearing on

"MONOPSONY ISSUES IN AGRICULTURE: BUYING POWER OF PROCESSORS IN OUR NATION'S AGRICULTURAL MARKETS"

Welcome to today's hearing on "Monopsony Issues in Agriculture."

By far, the most common response to the announcement that the Judiciary Committee would be having a hearing on monopsony issues in agriculture has been: "A hearing on what?" A close second has been: "What is monopsony?" My favorite response, however, has come in the form of several e-mails from helpful individuals who have insisted that there is a typographical error in the hearing title.

As I am sure everyone here today already knows, monopsony is to sellers what monopoly is to buyers. Just as the sole *seller* in a market – a monopolist – is able to charge more than the competitive price for a product, the sole *buyer* in a market – a monopsonist – is able to pay a lower price than it would in a fully competitive market. Thus, when discussing monopsony issues, one of the principal concerns is that a buyer with market power may use that power to reduce the quantity that it purchases in order to force down the per-unit price that it pays for a product. This leads to the inefficient allocation of resources and a resulting reduction in economic welfare just as surely as does the abuse of monopoly power.

There is no question that most farmers receive significantly less for their product today than they did 15 years ago. There are not many other Americans who can say their salaries have dropped over that same period of time. Now, if the price of agricultural products has fallen because of increased efficiency, that is a good thing for consumers. However, if prices are lower because processors have abused their market power to force them below competitive levels, then both farmers and consumers will ultimately be harmed.

Another potential abuse of monopsony power arises in the area of non-price terms. Rather than forcing a lower price, a powerful buyer may instead choose to use its power to insist that a seller accept less favorable contract terms than would be negotiated in a competitive market. This also is a concern in the area of agriculture. For example, many argue that producers are forced to accept binding arbitration clauses that leave them without satisfactory recourse against processors. Again, if such contract terms reflect the abuse of market power by processors rather than market efficiencies, both agricultural producers and consumers will be harmed.

These and other important issues will be discussed by our distinguished witnesses today. In particular, I would like to welcome Assistant Attorney General Pate and Dr. DeeVon Bailey. Mr. Pate hasn't been on the job all that long, but I like what I've seen so far. Mr. Pate had the good sense to hire my former chief counsel, Makan Delrahim, which is a testament to his good judgment. Dr. Bailey is a professor of Agricultural Marketing and Price Analysis and has focused in his academic work on agribusiness concentration. I consider him one of the most knowledgeable academics in this field. He recently won the E.G. Peterson Extension Award, which is probably the most prestigious recognition a professor can receive at Utah State University. I have often relied on his expertise over the years on agricultural policy questions.

I'd like to welcome all of our witnesses, and thank them for coming. I look forward to their testimony.

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United States Senate

WASHINGTON, DC 20510

Statement of Senator Herb Kohl
Committee on Judiciary
Hearing on Concentration in the Agriculture Industry
October 30, 2003

Mr. Chairman, thank you for holding this important hearing to examine the troubling trend of increased concentration in the agriculture industry. Congress has spent considerable time debating this issue, but little has been done to respond to the alarming transformation of rural America. Increased concentration on the buyer side has dramatically shrunk the market for farm products driving many farmers out of business. It is clear that – now more than ever -- we need vigorous and aggressive enforcement of our antitrust laws to prevent concentration that harms competition in this marketplace.

Our hearing today must be the beginning of a serious examination of whether our antitrust laws are being properly enforced to prevent excessive agricultural consolidation. We have seen greater and greater growth in processor buying power with apparently little being done by our antitrust regulators to stop this dangerous trend. Antitrust enforcers should not permit the creation of dominant market power by a buyer of agricultural products any more than it would permit the creation of monopoly by a seller. In addition, antitrust regulators should be sensitive to the effects of consolidation in regional markets as many agricultural products are perishable. And we must ensure that the Justice Department devotes sufficient resources and staff to the agricultural sector.

Our farmers and ranchers -- less than two percent of the population – produce the most abundant, wholesome, and by far the cheapest supply of food in the world. However, the manner in which they do that job has changed dramatically over the last few decades. Processors of farm commodities are relying more and more on contractual agreements rather than buying on the open market. As spot markets disappear for lack of buyers, farmers have no choice but to enter into contracts with processors who set the price and quantity without regard to the discipline of the free market. And prices fall for farmers as they find fewer and fewer markets for their product. Despite this, prices stagnate or even rise for consumers as the savings from squeezing the farmers get collected by the bloated middle.

This trend is evident across commodities. From 1993 to 2001, the share of hogs sold through contractual arrangements increased from 10 percent to 72 percent. In poultry, nearly 100 percent of the market depends on contractual arrangements. And of great concern to me, the dairy industry is also starting to experience the effects of processor concentration.

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Dairy producers in Wisconsin and around the country recently emerged from a 20 month period where milk prices hit a 25 year low. The U.S. fluid milk market is a $23 billion a year industry. Thirty five percent of that market is controlled by four firms. And in 2001, Suiza, the second largest processor of fluid milk formed a joint venture with the nation's largest dairy cooperative, Dairy Farmers of America (DFA). The combination of Suiza and DFA now control approximately 70 percent of the fluid milk processing and distribution in 13 Northeastern States. In regards to other dairy products, Kraft dominates the cheese market with nearly a third of that business, and Land O'Lakes controls about 30% of the butter business. And it is not only on the processing side where we see increased consolidation – the retail sector is also experiencing significant restructuring. In 2000, the top 5 grocery retailers -- Kroger, Wal-Mart, Albertson, Safeway, and Ahold -- controlled 42 percent of the market.

But this concentration in buying power at the processor and retail level has not led to commensurate lower prices for consumers. In fact, two months ago, when the national average price paid to farmers for fluid milk declined by 13%, the average national retail price paid by consumers at the grocery store declined by only 5.5%.

Rural America is in crisis. A way of life, an economy, countless communities, and too many farm families are struggling because there is a dwindling free market for American agriculture's superior product. This situation disturbs me greatly, and even more disturbing is the fact that the Justice Department appears to have done little to halt this trend.

We need to revisit the way our antitrust laws are being applied to agriculture. We need to discard the outmoded doctrine that buying power is treated with a lower degree of scrutiny than the aggregation of selling power by sellers. A monopsony among food processors ought to be permitted no more than we would allow a monopoly among food retailers. And dominant market shares in regional markets should be permitted no more than dominance in national markets.

And we need to ensure that the Justice Department enforcement tools are adequate to do their vital job. We were pleased several years when the Justice Department appointed, at our request, a Special Counsel responsible for competition in agriculture. However, serious questions have been raised as to whether the Justice Department has devoted sufficient resources to this task. We will carefully scrutinize the Antitrust Division to examine that it is devoting sufficient resources and staff to competition in agriculture.

I am please to welcome our panel of witnesses here this afternoon. Specifically, I would like to welcome Dr. Peter Carstensen from the University of Wisconsin Law School. I have always been impressed with your work on this issue Dr. Carstensen, and I am pleased that you can join us today. I look forward to a productive hearing.

U.S. SENATOR PATRICK LEAHY

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Opening Statement of Senator Patrick Leahy
Ranking Member, Senate Judiciary Committee
Hearing on "Monopsony Issues in Agriculture: Buying Power of Processors in Our Nation's Agricultural Markets"
October 30, 2003

Mr. Chairman, I want to thank the Committee for convening this hearing to examine the buying power of processors in our nation's agricultural markets. I would also like to thank our witnesses today, especially Dr. Ronald W. Cotterill, Professor of Agricultural and Resource Economics at the University of Connecticut, who I have enjoyed working with on dairy policy over the years.

The focus of this hearing is the increasing power of large concentrated agriculture processing firms, and their ability to lower the prices received by farmers who supply them with milk and meat and grain. This trend is having a tremendous impact on the lives and livelihoods of American farmers in virtually every region of the country.

In my own State of Vermont, agriculture is a vital industry and dairy is king, accounting for roughly three-quarters of our state's net farm income. For decades, dairy farmers seemed immune from the consequences of restructuring because, through their cooperatives, they also served as milk processors for their local or regional markets. National markets did not exist. That structure has changed dramatically over the past several years. As a result, our farmers are not getting a fair share of the retail price of milk, while giant, corporate processors are raking in anti-competitive profits as they simultaneously raise prices to consumers.

My major concern in New England relates to Dean Foods Inc., which merged with Suiza Foods in 2001 to form the largest milk processing company in the world. I was surprised and disappointed when the Justice Department's Antitrust Division approved this merger, because it meant the new company would control almost 70 percent of the milk supply in New England. It achieved this market dominance by buying up local dairies and then closing them down.

Moreover, Dean Foods now controls more than 30 percent of all milk production nationally, in addition to having strategic alliances with other entities that expand its influence even further. Dean Foods has an alliance with Dairy Farmers of America (DFA), a massive cooperative now representing 22,000 dairy farmers in 43 states. DFA was formed in 1998 through the mergers of a number of cooperatives, including Mid-America Dairymen, Milk Marketing Inc., and the Western Dairymen Cooperative. DFA

also owns Borden Foods. Dean Foods also has an alliance with Land O'Lakes, which was recently expanded to include a new licensing arrangement that grants Dean Foods a perpetual license to use the Land O'Lakes brand name nationally on a broad range of fluid milk and cultured dairy products, including all basic fluid dairy products, as well as a variety of other value-added products. Sales through these inter-locking deals between Land O'Lakes, DFA, and Dean Foods total over $12 billion annually.

More recently, I have been concerned about last year's proposed merger between H.P. Hood Inc. and National Dairy Holdings, which is why I led a bipartisan group of 10 Senators in asking the Justice Department's Antitrust Division to investigate the merger. H.P. Hood, a New England icon, attempted to acquire the much larger National Dairy Holdings from Dairy Farmers of America and other investors. DFA owns a controlling interest in National Dairy Holdings, which was created as a spin-off in the Dean Foods/Suiza Foods merger. As a condition of the sale, DFA would have had an exclusive right to supply milk to all H.P. Hood plants -- including those currently supplied by other dairy cooperatives, such as Agri-Mark. DFA has similar exclusive-supply agreements with Dean Foods and other fluid milk processors. This merger would have allowed one company -- DFA -- to control more than 90 percent of the New England fluid milk supply, with exclusive supply agreements with both Dean Foods and Hood Milk.

Fortunately, as a result of government antitrust scrutiny, H.P. Hood withdrew its original plan to merge with National Dairy Holding in May. While the merger is currently being restructured, we continue to be in a position where a handful of affiliated firms control access to a majority of the markets for milk in this country.

Opportunities for dairy farmers to market their milk independently have been all but eliminated. Today, two cooperatives control access to most of the nation's processing facilities and are using this access to expand further. This is not good for dairy farmers, it is not good for other market participants, and it is not good for consumers. In a competitive market, when input costs fall, competition tends to drive consumer prices lower, thus ensuring that manufacturers do not realize windfall profits. But not so in the dairy industry: Retail prices for fluid milk are virtually unchanged this year, even though prices farmers receive for their milk fell nearly fifty cents per gallon over an 18 month period in 2002-2003.

I continue to believe that the Justice Department and other government agencies should investigate why lower farm prices for milk have not been passed on to consumers. That is why I have asked the watchdog agency of Congress – the General Accounting Office – to investigate the widening disparity between farm and retail milk prices that has caused such financial hardship for northeast dairy farmers.

It is important for Vermont, and the dairy industry countrywide, to establish greater protections against market abuses by powerful agribusiness interests. The American people and the farmers who produce America's agricultural goods deserve strong watchdogging by their government to protect against abuses, and strong watchdogging works. In 1989, I asked for a Federal Trade Commission investigation and authored

legislation, which became law, to impose massive fines on manufacturers of infant formula for anticompetitive behavior. In 1992 I authored legislation, which became law, to bar companies convicted of school lunch milk price fixing from participating in the school lunch programs.

Last year, I cosponsored legislation with Senator Daschle and 14 of our colleagues to enhance fair and open competition in the production and sale of agricultural commodities. Our bill, S.20, would strengthen laws prohibiting anti-competitive activities currently in the Packers and Stockyards Act by broadening their scope to protect producers of *all* commodities (rather than only covering cattle, hogs, and sheep) and by adding provisions related to price discrimination, whistleblower protection, and limitations on the use of "right of first refusal" contract provisions. Among its many provisions, our bill would expand the standard of review for mergers and acquisitions to include impacts on rural communities, similar to the manner in which the Surface Transportation Board and the Federal Communications Commission consider other factors when reviewing railroad and telecommunications merger proposals.

During our work on last year's Farm Bill, I also supported bipartisan efforts led by Senator Tim Johnson and Senator Charles Grassley to ban the ownership of livestock by meatpackers for more than 14 days prior to slaughter. Unfortunately, the packer ban provision was killed by House conferees while the Farm Bill was being negotiated in conference committee last year.

In addition, last year's 2002 Farm Bill came close to taking another important step to level the playing field for independent producers by providing protections for producers who use production contracts. Many farmers are forced to sign mandatory arbitration clauses, as part of a take-it-or-leave-it, non-negotiable contract with a large, vertically integrated processing firm. In doing so, farmers are forced to give up their basic constitutional right to a jury trial, and instead must accept an alternative dispute resolution forum that limits their rights and is often prohibitively expensive. The Farm Bill would have ensured that the decision to arbitrate is truly voluntary and that the rights and that remedies provided for by our judicial system are not waived under coercion, much like the car dealer arbitration provision passed by this Committee in 2002. While this provision was removed in conference, Senator Grassley and Feingold have reintroduced the Fair Contracts for Growers Act (S.91), which would simply give farmers a choice of venues to resolve disputes associated with production contracts.

As the Farm Bill debate demonstrated, powerful interests are opposing our efforts to provide free and fair markets for all agricultural producers. And that is why hearings like this are especially important. I look forward to the testimony of today's witnesses as we continue to seek new ways to address these problems, to improve market opportunities for America's farmers and ranchers, and to protect both farmers and consumers against those who are able to wield enormous power against their interests.

# # # # #

Hearing on "Monopsony Issues in Agriculture"
Testimony of the National Council of Farmer Cooperatives
Submitted to
The Senate Committee on the Judiciary
U.S. Senate
Washington, DC

The National Council of Farmer Cooperatives (NCFC) appreciates very much the opportunity to submit this statement for the record with regard to the recent hearing on "Monopsony Issues in Agriculture," held by the Senate Committee on the Judiciary.

NCFC is a national association representing America's farmer cooperatives. There are nearly 3,000 farmer cooperatives across the U.S. whose members include a majority of our nation's more than 2 million farmers, ranchers and growers. These farmer cooperative businesses handle, process and market agricultural commodities and related products, furnish farm supplies, and provide credit and related financial services. Earnings from these activities are returned to their members on a patronage basis. Farmer cooperatives also provide jobs for nearly 300,000 Americans, many in rural areas, with a combined payroll of over $8 billion.

The food, natural fiber and agriculture system is currently undergoing the most dramatic and comprehensive structural change in our history. From the retail counter to the farmer in the field, the system is changing in response to global economic, social and political pressures. Increasing consolidation, especially in the retail sector, and efforts to further reduce costs at every level, continue to result in traditional business structures being reexamined, redefined and restructured throughout the entire marketing chain.

While farmer cooperatives continue to play a significant role in this changing marketplace, accounting for 28% of all farm supply sales and 29% of all commodities marketed by farmers as estimated by USDA, they must increasingly compete with firms that are much larger, better capitalized, and that are becoming even more dominant in terms of size and market influence.

A recent market analysis, based on USDA and related information, found the following:

- The Top 10 firms in the farm supply, food processing and food retailing sectors, for example, have average total sales of approximately $25 billion – *more than eight times greater than the average for the Top 10 farmer owned cooperatives ($3 billion).*

- The Top 10 firms in the farm supply, food processing and food retailing sectors have increased their market share above 40 percent in each sector.

- *Most significantly, no individual farmer cooperative has sufficient sales in any of these aggregate industry segments to be among the Top 10 firms.*

As their major competitors and customers have grown or consolidated to achieve the size and scale needed to compete in the domestic and international marketplace, farmers and their cooperatives have had to look at similar strategies. These include merging with other farmer cooperatives as well as entering into joint ventures and strategic alliances to help reduce costs, be more competitive, and better meet customer demands.

For farmer cooperatives, such strategies have also been critical to help protect the economic interests of their farmer members, provide them with competitively priced production inputs, maintain market access for their commodities and related products, and better enable them to capitalize on new value-added market opportunities beyond the farm gate. Earnings from such activities are returned by cooperatives to their farmer members on a patronage basis, helping further improve their overall income from the marketplace.

As Congress looks at ways to address concerns over increasing concentration in the food and fiber sector, it is important that such actions do not result in making it more costly and more difficult for farmers and their cooperatives to strategically position themselves to compete in a changing global economy. The practical effect would be to lock farmers and their cooperatives into a permanent disadvantage relative to their competitors. And, in business if you don't meet the competition, you won't be in business very long.

Farmer cooperatives, it should be emphasized, are farmers. They exist for the mutual benefit of their farmer members. When it comes to mergers and consolidations, not only must the cooperative's farmer elected board of directors approve the decision, in most cases, so must a majority of the cooperative's farmer members. Many states (including Iowa, Minnesota, North and South Dakota, and Wisconsin) even require a two-thirds majority vote of a cooperative's members before a merger can be approved. For this reason, any proposal that limits or restricts the ability of farmers to join together in cooperative self-help efforts, or to act for their mutual benefit, should be opposed.

There are, however, a number of actions that Congress and the Administration can and should take. These include: (1) maintaining and strengthening the ability of farmers to join together in cooperative self-help efforts; and (2) making sure existing antitrust laws are fully enforced.

The need for public policy to maintain and strengthen the ability of farmers to join together in cooperative self-help efforts is more important today than the 1920's when similar concerns led to passage of the Capper-Volstead Act.

The farmer's share of the consumer food dollar has now declined to where it now represents just 15 percent - its lowest level ever. Reversing this decline would substantially improve the farmer's economic well being. For example, increasing the farmer's share of the consumer food dollar by just one percentage point to 16 percent would generate an additional $6 billion in gross revenue.

Again, to be successful in helping farmers reverse this trend, public policy must maintain and strengthen their ability to join together in cooperative self-help efforts. NCFC, therefore, recommends the following additional actions by Congress and the Administration:

(1) Revitalize USDA's historic mission to encourage and enhance the ability of farmers to join together in cooperative self-help efforts. This includes reestablishing a separate agency within USDA to carry out such programs, along with providing adequate funding and resources for research and technical assistance. Recently, the Administration and Congress joined to create a new Assistant Secretary of Commerce for Manufacturing to help respond to the challenges facing domestic manufacturers. The challenges facing farmers and their cooperatives should be given a similar priority.

(2) Conduct a full review of existing USDA and other programs to ensure they serve to help encourage and enhance the ability of farmers to join together in cooperative self-help efforts.

(3) Modify existing law to better enable farmers to join together in cooperative efforts. This includes enactment of legislation as contained in S. 785/ HR 1671 eliminating the current triple tax on farmer cooperative dividends paid on capital stock under the Dividend Allocation Rule. Because of the Dividend Allocation Rule, farmer cooperative dividends are taxed as much as 60% higher than regular corporate dividends. Eliminating this unfair tax penalty is critical to better enable farmer cooperatives to raise the equity capital needed to compete in this changing business environment and as a matter of tax fairness. Another key change involves modernizing the federal Farm Credit Act to reflect changing state laws so that farmer cooperatives, including new generation cooperatives, continue to have access to a competitive source of credit capital through CoBank, their cooperatively-owned lender, for the benefit of their farmer members.

(4) Support additional initiatives aimed at helping further enhance the ability of farmers to join together in cooperative self-help efforts.

Together, these actions would help farmers improve their income from the marketplace, better manage their risk, capitalize on new value-added opportunities, and compete more effectively in a rapidly changing global marketplace. Strengthening their ability to join together successfully in cooperative self-help efforts would also help preserve their independence and promote their economic being long term.

Again, the National Council of Farmer Cooperatives wishes to express its appreciation for the opportunity to share its views on this important issue and we look forward to working with the members of this Committee in support of these objectives.

WRITTEN TESTIMONY OF
THE ORGANIZATION FOR COMPETITIVE MARKETS
presented to the
UNITED STATES SENATE
COMMITTEE ON THE JUDICIARY

Hearing Topic: "Monopsony Issues in Agriculture"

Hearing Date: October 30, 2003

Thank you Chairman Hatch, Senator Leahy and members of the Senate Judiciary Committee for allowing the Organization for Competitive Markets to submit this testimony for the record. OCM is a multidisciplinary nonprofit organization that focuses exclusively on antitrust and competition problems and solutions in agriculture. Our members consist of farmers, ranchers, academics, policy makers and agricultural businessmen. This testimony outlines our thoughts on how to think about monopsony in agriculture.

The core point to this testimony is that monopsony is bad for economic productivity, as well as for farmers and consumers. Further, while monopsony is the conceptual mirror image of monopoly – in that we are looking at purchases by Power Buyers rather than sales by Power Sellers – there are several crucial differences that prevent application of standard monopoly analysis to the monopsony problem in agriculture.

Federal farm policy has been based upon the goal of maintaining a diverse, family farm based production sector and providing consumers with a nutritious, affordable food supply. These goals are being circumvented by horizontal concentration and vertical integration which is driving farm prices down to sub-competitive levels and consumer prices above competitive levels.

A. The Problem of Horizontal Concentration

Basic economic theory, agreed to by both Chicago School and post-Chicago School economists, informs us that monopoly (one powerful seller) and oligopoly (a handful of powerful sellers) are potentially harmful to economic productivity because the dominant firm(s) has the ability to raise prices above competitive levels. This is accomplished by artificially reducing supplies below an amount that would be produced in a competitive environment. In true OPEC fashion, artificially reduced supplies increase prices. Artificially reduced supplies also mean less economic productivity because the economy is not operating at full production. Thus, the two-fold harm occurs in that consumers are charged high prices and overall economic productivity is dampened. This is rational behavior by Power Sellers who are maximizing profit, but it is harmful to the economic system.

On the buy side, basic economic theory, agreed to by both Chicago School and post-Chicago School economists, informs us that monopsony (one powerful buyer) and oligopsony (a handful of powerful buyers) are harmful to economic productivity because the dominant firm(s) has the ability to lower prices below competitive levels. Power Buyers reduce prices by artificially

constraining demand (not purchasing for their full plant capacity) in order to artificially reduce price. Artificially reduced demand lowers input prices for, in this case, farmers and ranchers. Artificially reduced demand also means less economic productivity because the industry is operating at full production. This profit maximizing behavior is "rational" for a firm, but harmful for the economy. But, as explained below, consumers do not benefit when Power Buyers drive down supply prices.

Though the lay opinion holds that the benefits of low processor input prices – even if artificially low – are passed through to consumers in the form of lower consumer prices, serious economists engaged in the subdiscipline of industrial organization know that this is not true. This attractive "price transmission theory" does not exist in practice because the Power Buyers sell their output in a market with its own competitive dynamics, unrelated to the input costs. In other words, the "market clearing price" determined by supply and demand in the Power Buyers' **output market** is independent and separate from the "market clearing price" determined by supply and demand in the Power Buyers **input market**. (Blair and Harrison, *Monopsony*, Princeton University Press, 1993). In fact, because Power Buyers generally have some sell-side power, their output prices are predictably above perfectly competitive prices to some degree.

The "price transmission theory" which is simplistically asserted by many to justify low farm prices as good for consumers is, thus, false because each step in the food chain is a separate and independent market primarily determined by supply and demand and the level of industry concentration between buyer and seller at each market interface. In agriculture, this means that the input costs determined in the farm gate market are a minor factor in determining the market price in wholesale or retail markets.

Where a Power Buyer purchases in an input market in which they have significant market power, and sells in an output market where it also has some market power, theory would predict an increase in gross profit – or price spreads (the difference between gross per unit sale prices and cost of goods sold). This is what has occurred in agriculture to harm both farmers and consumers.

The dominant firms in processing and retail have increased their margins significantly in the last 10 years. For example, since 1994 the farm-to-wholesale spread in beef has increased by over 50%, and in pork by over 43%. In poultry, processing companies have increased their net margin (wholesale price minus production and processing costs) by a whopping 193% since 1990. The wholesale-to-retail spread in beef and pork has increased by 35 to 37% in the last eight years. In poultry, retail prices have been held too high due to the tremendous increase in poultry integrator net margins.

The role of perishability is important in understanding the special monopsony problem that exists in agriculture. If the same market concentration exists both a perishable and a non-perishable product market, the market power problem is more severe in the perishable market because of the narrow window of time in which the product can be sold. If you have to sell because your product will devalue or "go bad", then the buyer has a major tool for pushing your price down. The highly perishable nature of agricultural products [i.e. livestock and poultry grow beyond their most valuable weight rapidly and must be sold very soon] means that producers cannot

withhold their product from the market in the hopes of receiving higher prices. Thus, producers have no ability to respond to artificially depressed prices by storing product. This is a recognized factor in antitrust law showing increased buyer power. (Todd v. Exxon, 2nd Circuit, Docket No. 01-7091, December 20, 2001).

The result is artificially high profits for processors while causing economic harm to consumers and livestock and poultry producers. This core realization that undue market power is bad for producers, consumers and the economy has resulted in a significant diversity of interest groups becoming concerned about this issue. This is a national problem causing the destruction of independent farms and ranches, the depopulation of rural communities and the price gouging of consumers.

B. The Problem of Vertical Integration

The cattle and hog sectors are partially integrated. Hogs are nearing full integration. Poultry is, for our purposes, fully integrated. The problems of partial and full integration will be discussed separately.

1. Partial Integration – Cattle and Hogs

The primary problems of partial integration, or captive supplies, in livestock are three fold.

First, demand is depressed for the open market livestock because packers bid less aggressively in the open market when they have a large quantity of their supplies committed. The open market is the source of price discovery for both the spot transactions and the contracts. If a packer has to slaughter 10,000 animals in a day, and bid for all those animals in the competitive market, it must bid aggressively to acquire them all. The price of the last animal purchased is the "market clearing price" because it is the largest amount that the buyer is willing to pay and the smallest amount that the seller is willing to receive for that last animal.

However, as is closer to today's facts, if a packer has to slaughter 10,000 animals in a day, and only must bid for 2,000 animals because the other 8,000 are committed through captive supply arrangements, it may bid far more conservatively for those animals. The "market clearing price" is set, in this scenario, on animal number 2,000 rather than animal number 10,000. The packer does not have to aggressively pursue the other 8,000 animals from other producers. The 1999 study of the cattle procurement in the Texas panhandle released by USDA was consistent with this principal. It found a robust correlation between increased captive supplies and lower prices. (Schroeter and Azzam, 1999).

Bob Peterson, former CEO of IBP, agreed publicly stating before the Kansas Livestock Association in 1988 that "forward contracts coupled with packer feeding could represent a significant percentage of fed cattle at certain times of the year. Do you think this has any impact on the price of the cash market? You bet! We believe a significant impact." We think it very hard to dismiss this admission from the executive of a dominant packing firm.

Second, when the price of livestock procured through formula contracts are tied to a market in which the packer participates, the packer has a tremendous incentive to negatively affect that market. Dr. Richard Sexton of the University of California – Davis, recently published a paper showing the profit maximizing strategies of packers, in mathematical terms, who can strategically use a combination of contract and open market procurement to push prices down and increase profit at the expense of producers. Dr. Wayne Purcell of Virginia Polytechnic University, who opposed the packer ownership prohibition due to his view of pro-competitive effects of captive supplies, recognizes this principle. Purcell stated in USDA testimony in 2000 that "[w]hether buyers attempt to manipulate the cash market to which the contract price is tied is somewhat immaterial because the incentive to do so is present and is undeniable."

Third, captive supplies result in very thin – or low volume – spot markets. The spot market is important because it sets the price for all the livestock of all types, and is the predominant factor for price discovery on the Chicago Mercantile Exchange. However, auction theory is clear that low volume markets in which dominant buyers interact always produce lower prices than high volume markets. Further, dominant buyers have far more ability to manipulate low volume markets than high volume markets.

Thus, partial vertical integration gives rise to powerful opportunities to manipulate markets and depress prices.

2. Full Integration - Poultry

The fully vertically integrated poultry sector has no open market price to manipulate. Rather, integrators generally enjoy regional monopsonies in which they contract with clusters of producers within a reasonable transportation distance of the processing plant. These regional monopsonies result from both geography and the industry practice of not competing for growers after a grower has a relationship with another integrator.

The producer-integrator relationship is not buffered by a market interface. Rather, it is directly controlled by the terms of a contract that is drafted by the integrator and offered on a take-it-or-leave-it basis to prospective growers. At the initiation of the contract relationship, the prospective growers receive promises from the integrator with regard to the legitimate expectations of a future relationship. The promises are generally oral and buttressed by brochures. No contract is presented or signed. Rather, a "commitment letter" – that is not a contract – is sent by the integrator for the grower to use to obtain a bank loan to build very expensive, single use poultry buildings. Banks loan this money without a contract because their loans are federally guaranteed.

The grower never sees a contract until after the loan is obtained, the buildings are built, and the first birds arrive. As the delivery truck sits in the driveway, the grower is presented with a contract to sign. The contract is drafted by the integrator, not subject to negotiation or modification by the grower, and offered on a take-it-or-leave-it basis. The grower must sign because if he/she does not, the truck will back out of the driveway and the grower will have no birds to grow, no income, and a high six-figure mortgage to repay. In other words, the prospect

of tremendous economic losses to the grower resulting from not using the buildings for birds is staggering in amount. The grower must sign the contract.

Thus, the industry structure, custom and practice give rise to tremendous opportunities for integrator abuse. The integrators have fully utilized these opportunities. The integrator has the ability to depress prices to a point where continuing a contract relationship is slightly better for the grower than bankruptcy. That is why the growers continue in a relationship that we on the outside would think irrational. The integrator can also extract non-price benefits in the form of contract terms that shift risk to the grower, impose significant duties on the grower, require mandatory arbitration in an unfair and expensive forum and allow the integrator the right of unilateral contract modification or termination.

C. The Department of Justice Antitrust Division

There is no dispute that the Department of Justice (DOJ) has the ability to enforce the antitrust laws as they apply to monopsony. However, DOJ has rarely done so. DOJ has little inclination to so enforce because of their limited experience and the lack of monopsony specific guidelines. DOJ also lacks guidelines to address the problem of vertical integration. The combination of vertical and horizontal consolidation result in very negative synergies which cause the harms discussed above.

DOJ should focus a portion of its staff on monopsony to develop policies and guidelines to address this problem, and to inform and advise the litigation staff when considering whether to prevent a merger or enforce the antitrust laws. DOJ should reject the naïve approach of the "price transmission theory" and it should also reject national market share as relevant for monopsony in agriculture. (OCM understands that DOJ cleared both Smithfield Foods and Cargill to purchase Farmland Foods pork this month in part because national market share in pork slaughter would not rise above 30%). DOJ should incorporate the understanding that (1) regional monopsonies in agriculture create local harms that should be addressed and that aggregate into national harms; (2) efficiencies are no defense unless actually proven rather than rhetorically asserted; (3) perishability is a major factor in the power relationship; (4) bad practices are not only likely to arise in agricultural processing because of concentration, but have historically arisen even without the modern level of concentration; (4) producer choice in marketing options is an antitrust harm just as consumer choice is a harm; and (5) innovation will suffer with so few competitors.

From a legislative perspective, the lack of competition thwarts large portions of the hopes of federal farm policy. Subsidies are paid to producers selling in artificially low markets. Trade deals are sought with other countries to expand markets, but our producers sell into anticompetitive domestic markets. New uses are sought for farm commodities to expand demand, but the increased price spreads eviscerate the profit opportunities.

D. Conclusion

The breadth and depth of public support for increased enforcement of competition and fairness laws is tremendous. The general public does not agree that market failure is self-correcting

without rules. The general public does not agree that undue economic power should go unchallenged. Lastly, the general public does not agree that our country is better off with a few firms dominating a sector rather than many competitors competing on price terms and innovating with new products.

Technology has evolved to the extent that small firms are as efficient as large ones. Small firms can be extremely innovative – indeed they may be the primary source of innovation. Further, a diverse food production sector is deemed good by society in order to spread the benefits of the food and agriculture economy widely, so as to provide a needed economic stimulus to Rural America's towns, communities, churches and schools. We ask that you assert strong new leadership in this regard.

Thank you for your interest in this issue.

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Department of Justice

STATEMENT

OF

R. HEWITT PATE
ASSISTANT ATTORNEY GENERAL
ANTITRUST DIVISION

BEFORE THE

COMMITTEE ON THE JUDICIARY
UNITED STATES SENATE

CONCERNING

ANTITRUST ENFORCEMENT IN THE AGRICULTURAL MARKETPLACE

PRESENTED ON

OCTOBER 30, 2003

Good afternoon, Mr. Chairman and members of the Committee. I appreciate the opportunity to discuss antitrust enforcement in the agricultural marketplace, and in particular the role of antitrust enforcement in ensuring that agricultural markets are competitive, both on the selling side and on the buying side.

We know that the agricultural marketplace is undergoing significant change. Farmers are adjusting to challenges in international markets, to major technological changes in the products they buy and sell, and to new forms of business relationships between producers and processors.

In the midst of these changes, farmers in particular have expressed concern about the level of competitiveness in agricultural markets. Competition at all levels in the production process leads to better quality, more innovation, and competitive prices. Farmers know how important antitrust enforcement is to ensuring competitive markets. Enforcement of the antitrust laws can benefit farmers, as purchasers of goods and services that allow them to grow crops and raise livestock, and also as sellers of crops and livestock that feed people, not only in our country but also throughout the world.

The Antitrust Division takes these concerns very seriously and has been very active in enforcing the antitrust laws in the agricultural sector. Antitrust Division officials have also undertaken a special outreach effort in agriculture, meeting with producers and producer groups here in Washington and around the country to listen to their concerns and to improve everyone's understanding of the role that antitrust enforcement plays.

The antitrust laws apply in the same way in every industry, with a very few exceptions where their application is limited by specific statute; one exception important for agriculture is the Capper-Volstead Act, which permits agricultural producers to market their products jointly through cooperatives. In addition, certain industries are also regulated by government agencies under statutes that go beyond the antitrust laws to establish additional, industry-specific rules for appropriate behavior in the marketplace; for example, the livestock, meat-packing, and poultry industries are regulated by USDA's GIPSA under the Packers and Stockyards Act, a fair trade practices and payment protection law.

We are very much aware of the trends toward increasing concentration in some agricultural sectors. In particular, the steer-heifer side of the cattle slaughter market has been highly concentrated for some time, with four meatpacking firms now controlling over 80 percent of the market. Lamb slaughter is also quite concentrated. Hog slaughter, and processing of crops such as corn, wheat, and soybeans, are also moderately concentrated, at least at the national level, and may be more concentrated in some local areas. High concentration in a market is not in and of itself a violation of the antitrust laws. On the other hand, a high level of concentration increases the need for antitrust scrutiny. It is an important backdrop in all of our analyses.

<u>Monopsony</u>

Let me emphasize that the Antitrust Division closely looks at so-called "monopsony" concerns in merger enforcement. Monopsony is the mirror image of monopoly, except on the buying, not the selling, side of the market. One example of the exercise of monopsony power is a situation in which a purchaser with market power reduces the quantity it purchases in order to force down the per unit price it pays. As with an exercise of monopoly power, if the result of an exercise of monopsony power is that output falls below the competitive level, then overall economic welfare is thereby reduced.

A casual observer might believe that, if a merger lowers the price the merged firm pays for its inputs, consumers will necessarily benefit. The logic seems to be that because the input purchaser is paying less, the input purchaser's customers should expect to pay less also. But that is not necessarily the case. Input prices can fall for two entirely different reasons, one of which arises from a true economic efficiency that will tend to result in lower prices for final consumers. The other, in contrast, represents an efficiency-reducing exercise of market power that will reduce economic welfare, lower prices for suppliers, and may well result in higher prices charged to final consumers. Antitrust must distinguish these two situations and pursue enforcement against the latter, but not the former.

Consider first how a merger may lower the true economic cost of purchasing. An

example might be where a merger enables the firm to commit to larger orders and thereby permits its supplier to save on its costs by scheduling longer and less costly production runs. These cost savings typically will benefit both the merged firm and its suppliers, and to the extent they lower the buyer's marginal cost of production, will tend to be passed along to some extent to final consumers. The case where a merger lowers input prices for no reason other than that the merged firm can now exercise monopsony power is entirely different. If a buyer obtains market power through merger, and thereby is able to depress prices for the inputs it purchases below competitive levels, then producers of those inputs will have depressed incentives to produce, which will result in too few resources utilized to produce the inputs compared to what would be available in a competitive market. This is likely to harm both suppliers and consumers.

While we often speak of consumers as the targeted beneficiary of antitrust enforcement, suppliers also benefit, by having healthy incentives to provide the best products and services they can, with the expectation that they will be able to do so free from anticompetitive interference. And the overall U.S. economy benefits, as the products and services desired by consumers are produced more efficiently, in greater quantities, and at competitive market prices. A focus on promoting competition goes hand in hand with our taking enforcement action in a monopsony case when the facts warrant.

Enforcement Actions

We investigate and bring enforcement actions against three basic kinds of antitrust violations. First, we bring criminal prosecutions against hard-core forms of collusion, such as price-fixing and market allocation, that violate section 1 of the Sherman Act; we also bring civil enforcement actions under section 1 against joint ventures and other forms of collaboration among competitors when they have the effect of suppressing competition. Second, we bring enforcement actions under section 2 of the Sherman Act against monopolization or attempted monopolization, the use of predatory or exclusionary conduct to acquire or hold onto a monopoly. Third, we bring enforcement actions under section 7 of the Clayton Act to prevent mergers from substantially lessening competition in a market. Our goal in each instance is to promote competition as a means of ensuring that consumers get the benefit of competitive prices, innovation, and efficiency, free from artificially imposed restraints.

Collusion

The Antitrust Division has brought a number of criminal prosecutions under section 1 of the Sherman Act in recent years in the agricultural sector. Beginning in 1996 there was the prosecution of the international cartel for lysine, an important livestock and poultry feed additive, leading to Archer Daniels Midland paying a then-record antitrust fine of $100 million and three ADM executives being sent to prison. There was our prosecution beginning in 1998 of the international cartel for vitamins, another important

animal feed additive, in which F. Hoffmann-La Roche Ltd. of Switzerland and BASF Aktiengesellschaft of Germany paid record-breaking fines of $500 million and $225 million, respectively, along with numerous other corporate and individual convictions, multimillion-dollar fines, and prison sentences. This spring, another firm, DuCoa LP, pled guilty and was sentenced to pay a $500,000 fine, and this June we indicted DuCoa's former president. There was our prosecution beginning in 2001 of the cartel for MCAA, used to produce herbicides, in which the Dutch company Akzo Nobel Chemicals BV paid a $12 million fine and French company Elf Atochem paid a fine of $5 million, and one Akzo Nobel and two Elf Atochem executives went to prison; this year, an additional firm, Hoechst Aktiengesellschaft of Germany, pled guilty and was sentenced to pay a $12 million fine.

On a smaller scale, we also successfully prosecuted two cattle buyers in Nebraska a few years ago for bid-rigging in connection with procurement of cattle for a meat packer, after an investigation conducted with valuable assistance from USDA's GIPSA, which was investigating some of the same conduct under the Packers and Stockyards Act. Both individuals pled guilty and were fined and ordered to make restitution to the victims. These cases are notable in that they focus on "monopsony" type of harm – harm to producers – the direct victims of the conspiracy included agricultural producers in their role as sellers rather than as consumers. While we do not generally find sellers to be victims of collusion as often as we find buyers to be, the somewhat unusual structure of

the agricultural marketplace – with relatively more producers selling to relatively fewer packers and processors – presents more possibilities for sellers to be victims. The Antitrust Division keeps a lookout for violations of this kind and will prosecute them when the facts warrant.

Monopolization

Monopolization enforcement actions under section 2 of the Sherman Act are rare, not only in agriculture but in other markets as well. Section 2 monopolization violations require both that the firm have a monopoly – or, in the case of attempted monopolization, a very high market share and a "dangerous probability" of attaining a monopoly – and that the firm have engaged in predatory or exclusionary conduct in order to acquire or maintain its monopoly. The levels of single-firm market share required are typically much higher than what we have found in many agriculture markets in recent years. And it must be demonstrated that the conduct is actually harming competition, not just disadvantaging rivals. Let me give you an agriculture-related example of the kind of situation that might warrant enforcement action under section 2.

A minute ago, I mentioned the Capper-Volstead Act, which allows producers of agricultural commodities to form processing and marketing cooperatives – to engage in joint selling at a price agreed to by the producer members of the co-op – subject to certain limitations enforced in the first instance by USDA. Suppose a group of livestock producers were to form a cooperative, as some cattle producers have attempted to do in

recent years, to slaughter and process their own livestock for the wholesale market. Suppose also that there was an established meatpacker with monopoly power in the area in which the cooperative was setting up its business, and that the established meatpacker used its monopoly power to attempt to drive the cooperative out of the market by, say, cutting off access to transportation or to wholesale markets. That's a good example of the kind of conduct we would investigate as a possible violation of section 2.

Mergers

The Antitrust Division has brought a number of enforcement actions in recent years under section 7 of the Clayton Act to prevent anticompetitive mergers from being consummated in agricultural markets. We have either insisted that the merger be modified to remove the cause for antitrust concern or, when that is not possible, we have sought to block the merger in its entirety. There was our 1998 challenge to Monsanto's proposed acquisition of DeKalb Genetics Corporation, involving corn seed biotechnology innovation, in which Monsanto met our concerns by agreeing to spin off its claims to a new technology for introducing new traits such as insect resistance into corn seed, and to license its Holden's corn germplasm to over 150 seed companies that currently bought it from Monsanto, so that they would be free to use it to create their own corn hybrids if they chose. There was our 1999 challenge to Cargill's proposed acquisition of Continental's grain business, in which we protected competition in the purchase of grain and soybeans from farmers in a number of local and regional markets, as well as

competition in the futures markets, by requiring Cargill and Continental to divest a number of grain and soybean storage facilities in the Midwest, the West, and the Texas Gulf. There was our 1999 challenge to New Holland's proposed acquisition of Case Corporation, in which we protected competition in the sale of tractors and hay tools to farmers by requiring that the parties divest New Holland's large two-wheel-drive agricultural tractor and four-wheel-drive tractor businesses, and Case's interest in a joint venture that made hay and forage equipment. There was our 1999 challenge to Monsanto's proposed acquisition of Delta & Pine Land, involving cotton seed biotechnology, in which Monsanto abandoned the acquisition after we advised that we were prepared to challenge it in court.

More recently, there was our December 2002 challenge to Suiza Foods' proposed acquisition of Dean Foods, and our April 2003 challenge to Dairy Farmers of America's already-consummated acquisition of Southern Belle Dairy Co. LLC.

In Suiza/Dean, we required Suiza Foods to change its originally proposed acquisition of Dean Foods in two significant ways. First, we required Suiza to divest 11 milk processing plants in 8 states (Alabama, Florida, Indiana, Kentucky, Ohio, South Carolina, Virginia, and Utah) to preserve competition in markets for milk sold at school and at other retail outlets. Second, we required Suiza to modify its supply contract with DFA, who would also own half interest in National Dairy Holdings, L.P., the new firm to which the processing plants were being divested, to ensure that dairies owned by the

merged firm in the areas affected would be free to buy their milk from sources other than DFA.

In the DFA/ Southern Belle, we filed a civil antitrust lawsuit to compel DFA to divest its interests in Southern Belle Dairy. This 2002 merger between two dairy processors was not subject to the Hart-Scott-Rodino premerger notification requirements, because its dollar value fell below the statutory threshold for reporting, and the Division did not learn about it until after it had been completed. DFA's acquisition eliminated the only other independent bidder for school milk in the area, resulting in a monopoly in 47 school districts in Kentucky and Tennessee, and reduced the number of independent bidders from three to two in 54 other school districts in those two states. The Division is suing to restore competition for milk prices in those school districts. The enforcement action is pending.

In the meatpacking area, the Antitrust Division has carefully reviewed a number of proposed mergers in recent years. While we have not found enforcement action to be warranted in any recent meatpacking mergers to date, the firms in these markets know that we are looking at all such mergers closely. The Division's ongoing continued vigilance and aggressive investigation in this area has already led to one contemplated merger being abandoned. In 1993 and 1994, the Division received reports that Cargill's large meat-packing subsidiary Excel was looking into acquiring Beef America. Both of these packers were among the top five in the steer-heifer slaughter market, and our

concerns that competition in livestock procurement might be adversely affected by the merger – the "monopsony" concern – led us to open an investigation. We aggressively questioned Excel and others in the marketplace, clearly communicating our concerns. A Cargill executive has publicly stated that our investigation convinced the parties to abandon the merger.

In conjunction with our merger enforcement program, we also enforce the pre-merger notification and waiting period requirements of the Hart-Scott-Rodino Act. Our most recent HSR enforcement action is in the meatpacking area, filed in February of this year against Smithfield Foods for twice making stock acquisitions of its competitor IBP without notifying the antitrust enforcement authorities and observing the required waiting period to enable an appropriate antitrust review. While I am recused from this matter, I can inform you that the HSR Act exempts from its premerger filing requirements certain stock acquisitions that are "solely for the purpose of investment," and that the Division's complaint alleges that Smithfield's acquisitions were not exempt because Smithfield was also considering and taking steps toward a Smithfield-IBP combination. We are seeking a civil penalty of $5.478 million from Smithfield.

I would like to specifically point out that Cargill/Continental and, to an extent, Suiza/Dean are "monopsony" cases, in that farmers as sellers would have been the direct victims of the loss of competition that was expected to result from the merger as originally proposed. In Cargill/Continental, the parties were not only buyers of grain and

soybeans in various local and regional domestic markets, but also sellers of grain and soybeans in the United States and abroad. While we looked at the potential effects on competition in both the "upstream" and "downstream" directions, the challenge was based entirely on concerns about effects in the "upstream" market, where Cargill and Continental were buying from farmers. We carefully looked at each upstream market that could be affected, and traced the potential effect all the way from the local area in which the farmer grew and sold the grain or soybeans to a local elevator and the place at which Cargill or Continental made its final purchase – in some instances, a distance of over 1400 miles, from the farms in Minnesota to the port elevators in Seattle. The relief in the consent decree was carefully fashioned to address the potential competitive problems in each affected local market.

In Suiza/Dean, while the stated purpose of requiring Suiza to modify its supply contract with DFA was to ensure that dairies owned by the merged firm in the areas affected would be free to buy their milk from sources other than DFA, the effect of this was also to give competitive access to independent dairy producers.

Role of Antitrust Enforcement in the Agricultural Marketplace

As the above summary of our enforcement activities in the agriculture sector reflects, the Antitrust Division regularly has monopsony concerns on our radar screen. When those concerns are present we investigate them fully and, when the facts warrant,

we take appropriate enforcement action. Price fixing and other forms of collusion are just as unlawful when the immediate victims are sellers rather than buyers. And the Merger Guidelines we developed with the Federal Trade Commission, which set forth the analytical framework for all our merger enforcement, make clear that a competitive analysis of upstream market effects is to be a mirror image of a competitive analysis of downstream market effects. In both cases, we are looking at whether the merger is likely to create or increase market power, or to facilitate the exercise of market power, in any market; the Merger Guidelines define market power as the ability of a seller or coordinating group of sellers to profitably maintain prices above competitive levels for a significant period of time, or the ability of a buyer or coordinating group of buyers to depress prices below competitive levels and thereby depress output.

We listen carefully to the concerns of agricultural producers and producer groups as to how a proposed merger or a course of conduct might affect them, and we are equally concerned if the effect is anticompetitively low prices for products sold by farmers as if it is anticompetitively high prices for products purchased by farmers. We consult as appropriate with USDA, under longstanding practice as reflected in our Memorandum of Understanding, to get their views on how agricultural producers stand to be affected by the merger or practice in question, and to take advantage of USDA knowledge and expertise in agricultural markets.

As members of this Committee understand, the responsibility entrusted to us as

enforcers of the antitrust laws is not to engineer the best competitive structure for the marketplace. The antitrust laws are based on the notion that competitive market forces should play the primary role in determining the structure and functioning of our economy. Our job is to stop the specific kinds of private-sector activity that violate the antitrust laws from interfering with those market forces.

We do not have the power to restructure any industry, any market, or any company, or to stop any practice, except in a precise and focused fashion as necessary to prevent or remedy specific violations of the antitrust laws that we can prove in court. We are law enforcers, not regulators. Our authority rests ultimately on our ability to bring enforcement actions in court, and when we bring an action, it is the court that decides whether the antitrust laws are being violated in the particular instance.

While the antitrust laws play an important role in helping keep markets competitive, they will not address all of the complex issues facing American agriculture in this time of change. There are a broad range of agriculture policy issues for the government to focus on, and antitrust enforcement is only one part of that.

For us at the Antitrust Division, of course, it is the important part, because it is our part. We are committed to stopping anticompetitive mergers or conduct from harming the agricultural marketplace, whether it is buyers or sellers who are harmed in the first instance.

I would be happy to try to answer any questions the Committee may have.

TESTIMONY TO THE UNITED STATES SENATE JUDICIARY COMMITTEE REGARDING THE COMPETITIVE ENVIRONMENT FOR DAIRY AND LIVESTOCK PRODUCERS

October 30, 2003

My name is Robert D. Wellington and I serve as Senior Vice-President for Economics, Communications and Legislative Affairs for Agri-Mark Dairy Cooperative. Agri-Mark is a farmer-owned and controlled Capper-Volstead cooperative with approximately 1450 member dairy farms located throughout New York and the six New England states. We market about three billion pounds of farm milk annually. This represents slightly less than two percent of U.S. milk production.

While the Agri-Mark cooperative still has concerns regarding the competitive environment for the milk and dairy products produced and marketed by our member farmers and their neighboring farms, we also believe that the latest arrangement whereby the H. P. Hood Company will purchase the Crowley and Marigold companies, should have no impact on the competitive environment for producer milk as it exists today. Through the diligent work of the U.S. Department of Justice and many state attorney generals offices and the good faith efforts of the H.P. Hood Company owners and management and others, the Agri-Mark supply agreement with Hood will stay in place. As a result, dairy farmers in the Northeast region should continue to have alternative organizations available to purchase and market their milk

The original merger proposed by H. P. Hood and NDH included a full milk supply agreement for Dairy Farmers of America (DFA), one of the owners of NDH. This would have precluded markets for Agri-Mark members and would have proven very costly and also, in our view, would have jeopardized our very future.

The latest proposal of the H.P. Hood Company (The Crowley and Marigold purchase) does not include any formal supply agreement. Agri-Mark has also been assured by the owners of the H.P. Hood Company that our current supply contract will be fully honored into the future and that they have neither a formal nor an informal supply agreement or understanding with DFA <u>that there would be a full supply agreement in the future</u>. We have had an excellent working relationship with the owners and management of Hood since they bought the company. We have full confidence in the honesty and integrity of the Hood owners and management and have accepted their assurances to us as true and accurate.